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EXPLORING NEW FRONTIERS



ANNUAL REPORT

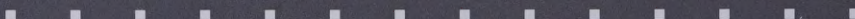
2005

PETROLIFERA PETROLEUM LIMITED

Petrolifera Petroleum Limited is a Canadian oil and gas company engaged in exploration and production activity in South America. Petrolifera's production base stems from its 100 percent-owned Puesto Morales/Rinconada Concession in the Neuquen Basin, Argentina. In 2005, several significant new light oil discoveries were made on this concession.



Petrolifera was also successful in negotiating two major petroleum and natural gas exploratory licenses covering over five million acres in the Marañon and Ucayali Basins of Peru during 2005. These blocks are considered to have substantial potential as they either are on trend with or offset significant crude oil or natural gas and condensate accumulations and are considered to be well-situated from a geological perspective.



Annual Meeting: May 10, 2006 - 3:00 pm MST
Bonavista Room | The Westin
320 4th Avenue SW Calgary, Alberta

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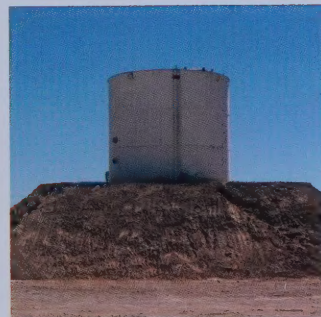
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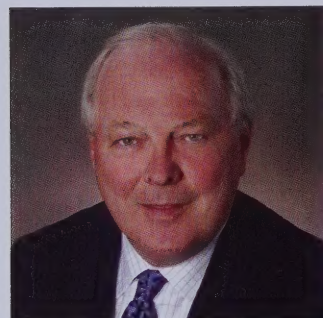
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Certain information contained in this Annual Report including the Letter to Shareholders, Review of Operations and Management's Discussion and Analysis include forward-looking information which is subject to risks, uncertainties and assumptions that are described herein. See page 24, Management's Discussion and Analysis for a discussion of these risks, uncertainties and assumptions.

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CORPORATE INFORMATION



RICHARD A. GUSELLA
Executive Chairman

LETTER TO SHAREHOLDERS

Petrolifera Petroleum Limited experienced an incredible year in 2005. It was highlighted by the drilling of several light gravity crude oil discovery wells on our Puesto Morales/Rinconada Concession in Argentina during the latter part of the year. These results translated into a significant appreciation of our share price following the company's initial public offering in November 2005. The reaction in the stock market underscores the appeal of organic growth and the excellent productivity encountered in the wells. It also reflects an understanding of the long-term potential of Petrolifera's significant Peruvian licenses secured earlier in the year.

Petrolifera completed two financings and went public in late 2005. Listed under the trading symbol "PDP" on the Toronto Stock Exchange, Petrolifera has become known as one of the most successful new issues in any industry in recent years. It is well on its way to becoming a significant South American production company. Our strategy is yielding results and we believe new opportunities can be secured.

EVOLUTION OF A SUCCESS

History

Petrolifera was originally created by Connacher Oil and Gas Limited as a sidecar company to liberate the value of Argentinean assets held by Connacher. It was apparent to Connacher in late 2004 that capital markets and investors were unwilling to recognize the potential of undrilled Argentinean prospects, in a positive manner for Connacher and its shareholders, when held inside a company emphasizing the Canadian oil sands. Accordingly, under a plan devised by the management of Connacher, a new company was created, new capital was secured, new technical expertise was identified and new opportunities were pursued. This has proved to be a successful initiative to the benefit of all Petrolifera shareholders, including Connacher.

In order to facilitate the creation of Petrolifera by giving it some critical mass, in late 2004 Connacher acquired the then-unowned 50 percent working interest in and operatorship of the Puesto Morales/Rinconada Concession. This included modest associated stripper production and crude oil and natural gas reserves. The property was acquired from an arm's length third party for US\$1.5 million. Subsequently, Connacher sold the consolidated 100 percent working interest to Petrolifera, then a wholly-owned subsidiary, for eight

million Petrolifera common shares from treasury and a \$4 million promissory note, which has since been repaid. Additionally, \$1.5 million of new outside capital was raised from private institutional and individual investors to give Petrolifera some working capital. This supplemented the modest revenue base it had acquired and provided third party validation of the term of trade. This reduced Connacher's ownership of Petrolifera to approximately 61 percent.

In late December 2004, opportunities to acquire new licenses in Peru were brought to Petrolifera's attention by Mr. Gary Wine, who was consulting to the company in Argentina and later, in March 2005, was appointed President of Petrolifera. Mr. Wine had spent a good part of the previous five years advising Perupetro, the Peruvian state agency, on geological matters and thus had secured extensive knowledge of local opportunities and procedures. Peru had recently revamped its tax, royalty and tenure policies as related to the award of new exploratory licenses. As a consequence, Peru had become among the most attractive countries for new energy initiatives in South America.

With Connacher's financial support and backing, and capitalizing on Mr. Wine's knowledge, Petrolifera moved quickly and in early 2005 was able to secure an agreement to acquire ownership and operatorship of two significant licenses covering more than five million acres in the Marañon and Ucayali Basins onshore Peru. The formal awards were made later in the year.

In March 2005, with the prospect of receiving the Peruvian licenses in hand, Petrolifera successfully raised \$7 million through the private placement of treasury shares and share purchase warrants. Connacher did not participate in this financing, so its equity stake in Petrolifera was reduced to 40 percent. Accordingly, by March 2005, Petrolifera was favourably positioned with attractive near-term opportunities in Argentina, solid

PETROLIFERA IS WELL ON ITS WAY TO BECOMING A SIGNIFICANT SOUTH AMERICAN PRODUCTION COMPANY. OUR STRATEGY IS YIELDING RESULTS AND WE BELIEVE NEW OPPORTUNITIES CAN BE SECURED.

working capital, attractive and significant longer-term assets in Peru and continuing financial and managerial support from its major shareholder, Connacher.

In the spring of 2005 an extensive 3D seismic program was initiated over a significant portion of Petrolifera's acreage in Argentina. This extensive acreage block, situated on trend with the giant Medanito complex of oil fields, had not seen any consequential modern exploration for over 30 years. Upon interpretation, the seismic data yielded a number of promising drillable prospects, with prospective multi-zone potential.

The company's initial public offering was completed in November 2005. The company's new issue was priced at \$1.75 per unit, consisting of one common share and one-half share purchase warrant, with one warrant and \$3 required to purchase one additional common share from treasury until May 8, 2007. In difficult market conditions, \$21.3 million of new equity capital was raised. By acquiring \$6 million or 28 percent of the new issue, Connacher was the largest purchaser, reaffirming its support for Petrolifera. Pro forma the financing, Connacher's equity interest in Petrolifera was reduced to 35 percent. Petrolifera's common shares were listed for trading on the Toronto Stock Exchange under the symbol PDP and the publicly-offered series of warrants were also listed under the symbol PDP.WT.

Since the initial public offering, we could not have asked for the company to put a better foot forward. Petrolifera drilled, logged, tested and completed six wells in Argentina between October 2005 and February 2006. Its common share price increased more than 700 percent as a result of the high caliber of the discoveries made, which included four exploratory wells and two development wells. Five wells were Sierras Blancas discoveries and Punta Rosada reserves and production were also identified and tested in three of these wells (1003, 1010 and 1011). All of the Sierras Blancas / Punta Rosada wells have flowed oil to surface through restrictive chokes at very attractive rates exceeding several thousand barrels per day. The 1005 well was a Quintuco test and this reservoir is expected to yield lower but commercial production levels.

Test rates were constrained by surface facilities, as is current production, but this is being addressed and Petrolifera anticipates its production from Puesto Morales to exceed 10,000 barrels per day by the fourth quarter 2006. This is anticipated to result in the generation of significant cash flow which will finance an anticipated \$33.2 million capital program during the upcoming year. This would mean Petrolifera can build significant cash balances so new equity financing is not required or anticipated. If additional drilling rigs become available, Petrolifera is likely to expand its capital budget later in 2006 to aggressively develop its Argentinean acreage, to pursue an expanded land base in the area and to expand opportunities elsewhere in Argentina, Peru and other selected Latin American countries.

Activity in Peru in 2006 will initially focus on completion of required environmental and community relations work before new seismic and drilling can proceed. We remain most constructive towards the prospective reserve potential of our lands in Peru, although this will be a longer-term project.

Petrolifera's objective is to become a sizeable South American oil and natural gas producer. With a sound financial position accompanied by the prospect of strong organic growth, efficient operations and the technical skill of a compact management group, Petrolifera's outlook is buoyant.

PEOPLE MAKE THE DIFFERENCE

During late 2005 and early 2006, Petrolifera was fortunate to attract solid and experienced professionals in both Buenos Aires and in Lima to establish our offices and to then direct in-country initiatives and programs. Carlos Mumbro and Carlos Monges are, respectively, our General Managers in Argentina and Peru and report to the President, Mr. Gary Wine. These individuals bring a strong knowledge of domestic affairs and geology and, under Mr. Wine's leadership and direction, are expected to make a significant contribution to our continuing success. Additional staff members have been hired or are being recruited to strengthen our regional offices.

Petrolifera was also able to attract highly-qualified and experienced individuals to join its Board of Directors

during 2005. In addition to the Connacher nominees (Mr. C.M. Evans, Mr. S.D. McGregor and Mr. R.A. Gusella), shareholders elected Mr. Don Barkwell, Mr. Gerrit Maureau, Mr. Chris Smith, FCA (ICAEW) and Mr. Wine to the Board. All of these individuals have extensive international oil and gas experience and have made a significant contribution to our progress. With its expanded board, Petrolifera is exerting all efforts to be in compliance with the prevailing governance initiatives of Canadian regulators and stock exchanges.

AN EXCELLENT OUTLOOK

The outlook for Petrolifera is excellent. Although there is a prevailing perception that political risk is higher in South America than might be encountered in North America, we are satisfied these risks are presently manageable. It is encouraging to be working in a country like Peru, in light of its newly-adopted positive policy framework, which provides a healthy investment climate. This is underscored by the extent to which the industry has followed our lead and tied up much of the remaining geologically attractive acreage in the months after we entered the country. We are also pleased with the mature and favourable operating conditions in Argentina. We hope market pricing will again emerge, providing more reliable signals to industry. This would promote reinvestment and encourage new exploration activity.

With such a compelling start, our challenge will be to consolidate our successes into a reliable and stable production profile in Argentina while pursuing new projects and preparing plans for drilling in Peru.

Our shareholders have experienced attractive gains to date and we trust your support will continue. Our appreciation is extended to Petrolifera's staff, Directors and members of the management group. In particular, we would also like to recognize Mr. Gary Wine's geological expertise and contribution to our early success.

Respectfully submitted on behalf of the Board of Directors,

"R.A. Gusella"
Executive Chairman
March 21, 2006

"G.D. Wine"
President
March 21, 2006



January 2006 — Investors Field Trip to Argentina

PETROLIFERA'S OBJECTIVE IS TO BECOME A SIZEABLE SOUTH AMERICAN OIL AND NATURAL GAS PRODUCER. WITH A SOUND FINANCIAL POSITION BACKED BY THE PROSPECT OF STRONG ORGANIC GROWTH, EFFICIENT OPERATIONS AND THE TECHNICAL SKILL OF A COMPACT MANAGEMENT GROUP, PETROLIFERA'S OUTLOOK IS BUOYANT

REVIEW OF OPERATIONS

Petrolifera's operations are in the countries of Argentina and Peru in South America.

In Argentina, Petrolifera owns a 100 percent working interest in the 95,000 acre Puesto Morales/Rinconada Concession located onshore in the Neuquen Basin some 965 kilometers southwest of the city of Buenos Aires. In 2005, we completed a 3D seismic program over a significant portion of the Puesto Morales and Rinconada blocks which comprise the concession. Late in the year we initiated a very successful drilling program on the Puesto Morales block and made six successive significant light gravity crude oil discoveries.

In Peru, we secured two major licenses over large onshore blocks in two separate basins with what we believe to be significant reserve potential. Block 106 in the Marañon Basin in northern Peru covers approximately two million acres and is prospective for medium gravity crude oil accumulations. Block 107 in the Ucayali Basin of southern Peru covers over three million acres and is on trend with the giant Camisea natural gas and condensate field. It also contains the potential for crude oil accumulations.



GARY D. WINE

President

ARGENTINA

In late 2004, Petrolifera acquired its 100 percent working interest in the Puesto Morales/Rinconada concession from Connacher Oil and Gas Limited, its major shareholder. This was done in conjunction with Connacher's plan to reorganize its international holdings in order to concentrate on domestic Canadian activities. To enact its plan leading to the creation of Petrolifera, Connacher had acquired the interests of the prior operator and fifty percent owner of the concession in an arm's length transaction for cash. Connacher then sold the combined 100 percent working interest to Petrolifera in exchange for common shares and a \$4 million promissory

note, coincident with Petrolifera raising new equity capital for working capital and to reduce its negotiated indebtedness. The concession contained established reserves which had been evaluated by an independent engineering company and a modest production base of approximately 85 bbl/d of stripper-type Quintuco crude oil production and associated and non-associated Quintuco natural gas production aggregating approximately 1 mmcf/d. This initial production base provided the company with a modest level of net operating income to cover overhead while efforts were pursued to secure other exploration opportunities and additional funding to finance growth activities.

The concession is well-situated in the Neuquen Basin and lies southeast of, and on trend with, the Medanito complex which produces significant volumes of crude oil from a number of productive horizons of Upper Jurassic age. Production from the Neuquen Basin is the largest contributor to Argentina's overall crude oil sales, which have been in decline in recent years, and is generally perceived to be a mature region.

The concession contains the Puesto Morales Sur oil field, which had been discovered by YPF (the former state oil company of Argentina) in the late 1960s and early 1970s. The field is thought to contain approximately 100 million barrels of original oil-in-place reserves, although production practices utilized in the past resulted in significant volumes of associated natural gas being flared. As a consequence, only about 10 million barrels of oil (or about 10 percent of original reserves) have been produced to date since the field was placed onstream. The company's stripper oil production comes from this field.

The concession has seen a series of owners prior to Petrolifera's acquisition of the block. Of considerable significance is that since it was originally sold by YPF in the early 1990s as part of a privatization process, rights

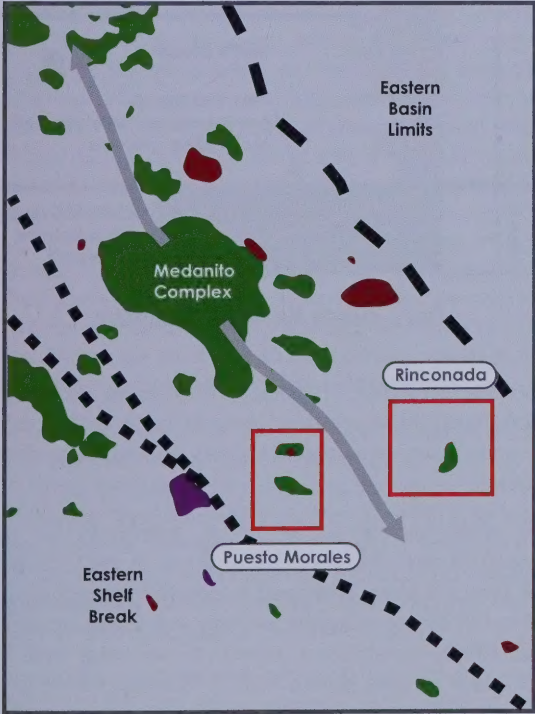


Fig. 1: Argentina Land Holdings

for zones other than those considered productive at the time of sale were retained by YPF until Connacher and its then partner were able to secure these rights in 2001. As a result, while many of the marginal blocks sold to industry at the same time this concession was vended by YPF were subjected to the application of modern seismic technology and new drilling, this did not occur on the concession until after 2001, and then was limited in scope due to the financial capacity of the owners and the economic collapse in Argentina during the early part of this decade.

In this period, some new seismic data had been secured by Connacher and its operator, Ingenieria Alpa, which led to the drilling of the PMNx-1001 well on the La Ramona prospect in 2003. This well, while eventually completed as a low rate producer of light oil from the Quintuco Formation, would ultimately be very significant for Petrolifera in that it did encounter and recover light gravity crude oil on test from what appeared to have been a transition zone in the Sierras Blancas Formation. This established the fact that the Sierras Blancas formation was charged with hydrocarbons in the region, setting up the geological model which Petrolifera has pursued with great success in late 2005 and early 2006.

2005 Activity

Petrolifera embarked on an extensive 3D seismic program in early 2005 at about the same time it was raising new capital for its ongoing business activities following the successful negotiation of new licenses in Peru. This program covered a significant portion of the Puesto Morales block and new data was also secured over Rinconada. On interpretation, numerous prospects and leads were established, with particular excitement surrounding the identification of Sierras Blancas structures. This raised the specter of discovering crude oil in excellent sandstone reservoirs, which were established as the primary objective of a proposed drilling program. Secondary objectives

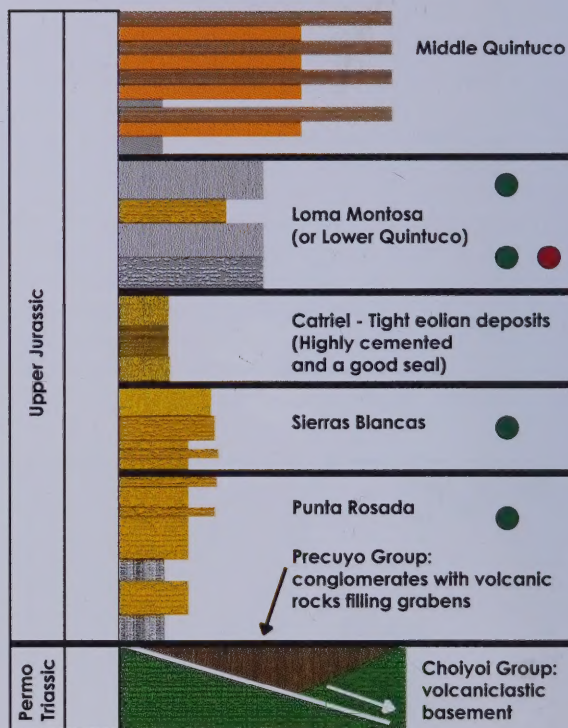


Fig. 2: Puesto Morales Stratigraphy

and the prospect of multiple pay zones were also recognized. An interesting Sierras Blancas stratigraphic pinchout play was also identified on the Rinconada block.

We were unable to secure a drilling rig for our proposed multi-well program until late in 2005, around the time we were engaged in another financing and listing our shares for public trading. A five well program was initially established, although we were able to complete six wells before having to return the rig to its original contractor in early 2006. As has been written elsewhere, the rest is history!

Outstanding Drilling Results

Our drilling program was a great success. A total of six wells: RN.PM.x-1002, 1003, 1004 and 1005 and RN.PM.a-1010 and 1011 (development wells as they offset 1003) were drilled to evaluate the Quintuco, Sierras Blancas, Punta Rosada and the remaining stratigraphic section down to basement. The 1005 well was designed as a Quintuco test to evaluate this stratigraphic play in proximity to the Puesto Morales Sur Field, and was not intended to test the Sierras Blancas within a prospective structural position.

All six wells have now been completed and tested as light gravity 35 degree API crude oil discoveries. The 1003 well was the first well tested and despite being limited by surface equipment during testing, flowed oil to surface, with no water, at over 8,400 bbl/d through a two inch choke on short-term tests from the Sierras Blancas (6,000 bbl/d) and Punta Rosada sandstones (2,400 bbl/d), situated at depths below 1,400 meters subsurface. This well is now producing at restricted rates of approximately 1,800 bbl/d through an eight millimeter choke with a one percent water cut. The well contains a hydrocarbon column of approximately 325 meters based on mud log shows and there are five untested zones in the up hole Quintuco Formation. These will be evaluated by drilling a twin well to 1003, as it was determined to be imprudent to test these zones with such a prolific flow rate from the other formations in the well. Quintuco flow rates are not expected to be as prolific as those encountered in the Sierras Blancas and Punta Rosada Formations.

The first well in the program, 1002, was tested at a later date after 1004 had tested flowing oil at rates up to 940 bbl/d from the Sierras Blancas through a one-half inch choke. The 1002 well flowed at rates of up to 2,340 bbl/d from the Sierras Blancas through a three-quarter inch choke, again with no water recovery on test and constrained by surface facility limitations. This well is shut-in awaiting access to treatment facilities.

The two development wells offsetting the 1003 discovery, 1010 and 1011, are both excellent Sierras Blancas and Punta Rosada discoveries, and tested flow rates of up to 4,200 bbl/d and 3,200 bbl/d respectively. As with other

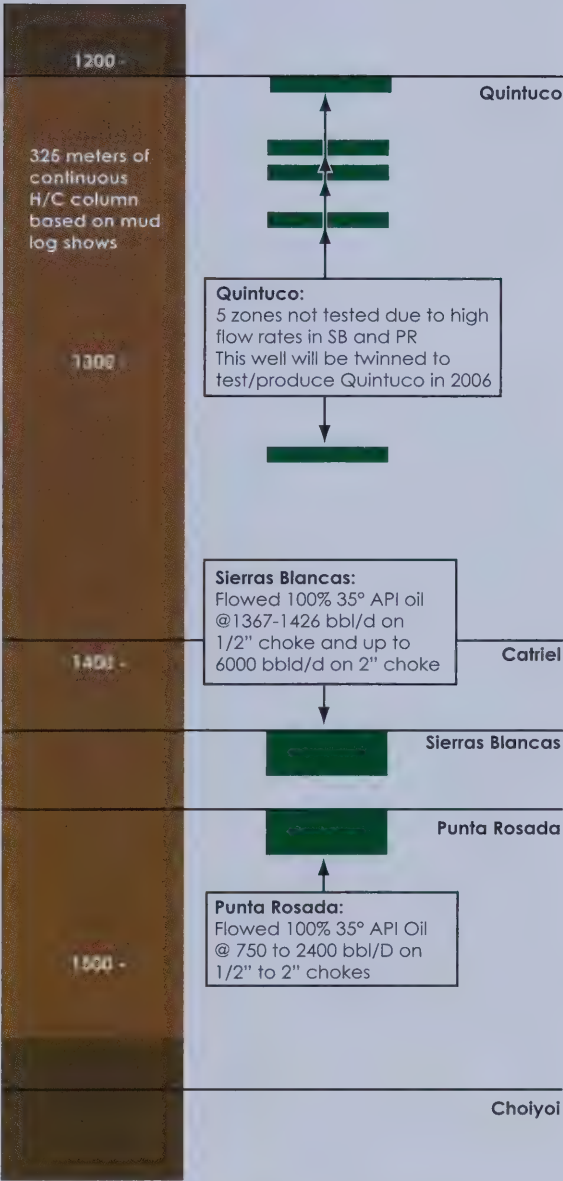


Fig. 3: Test Results on Rn.PM.x-1003

wells, no water was recovered on test and the flow rates were constrained by chokes and/or the capacity of surface separators. These wells were subjected to extended flow tests of several hours per zone.

The calculated cumulative flow rates from the 1002, 1003 1004, 1010 and 1011 wells, using consistent choke sizes of approximately three-quarter inch to one inch, is approximately 15,000 bbl/d. Flowing tubing pressures at the wellhead have remained excellent since production was initiated, primarily from the 1003 well, with no evident decline and a minor one percent water cut. Flow rates on test are not determinative of production rates, which may vary and variances may be material.

Production since discovery has been in the order of 2,200 boe/d with surface treatment facilities the major constraint. Recently, production increased to approximately 3,400 boe/d as Petrolifera commenced production from 1010 and started third-party processing. The crude oil produced is of excellent quality but it is a bit salty, and requires washing to remove the salt before it is marketable. Until its new treatment facilities and the proposed pipeline are in place, which is anticipated for around the beginning of the fourth quarter 2006, arrangements have been made to have the oil trucked to other facilities operated by third parties and then delivered to market. This can be accomplished for a

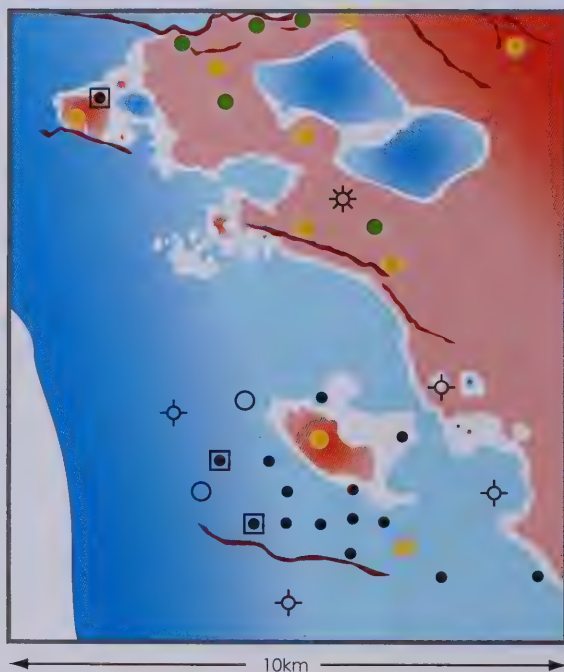


Fig. 4: Puesto Morales 2006 Sierras Blancas Program

- 2005/2006 Sierra Blancas/Puesto Morales discoveries
- Proposed wells for 2006
- Puesto Morales Sur oil wells
- ☼ Producing natural gas well

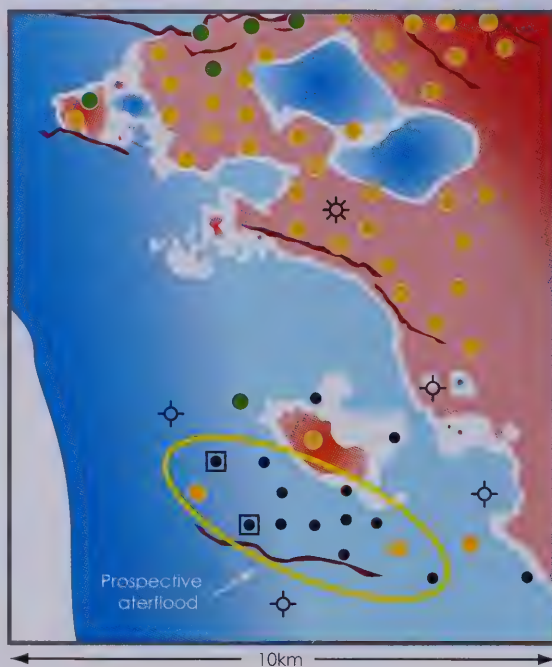


Fig. 5: Puesto Morales 2006 Quintuco Program

- uintuco discoveries
- Proposed wells for 2006/200 including twin wells
- Puesto Morales Sur oil wells
- ☼ Producing natural gas wells

modest fee of under \$1.00 per barrel, and if all current negotiations are concluded, up to 6,000 bbl/d of additional production could be onstream by the middle of the second quarter 2006. This would contribute significantly to Petrolifera's revenue and cash flow until its own permanent facilities are installed and operative.

The last remaining well, 1005, is an indicated Quintuco crude oil discovery. As of this writing, two zones in the Quintuco have been successfully tested after a mechanical frac, recovering oil at the combined rate of around 150 bbl/d. Two other zones are to be similarly stimulated and tested before the installation of a production string. The positive results from these zones thus far are encouraging in expanding the areal extent of the old Puesto Morales Sur field, which is a stratigraphic accumulation. As noted below, up to 13 additional Quintuco tests are scheduled for drilling on the Puesto Morales block in 2006 and these wells will contribute consistent long-life pumped production for many years. This will help to offset the inevitable future declines which will occur in the Sierras Blancas and Punta Rosada wells as they are placed onstream and produce over time.

Of considerable importance to the results of the 2005 and 2006 drilling to date is that a definitive oil/water contact has not been established in any of the Sierras Blancas/Punta Rosada zones, suggesting there could be considerable additional areal extent to these prospects than was originally contemplated. As confirmed by drilling, the success of our geological model enhances our confidence in extending the limits of the play and, as a consequence, an aggressive drilling campaign is set for the balance of 2006 and into 2007. Also, it is encouraging that, once onstream at 1003, the watercut is very minimal at one percent. The presence of a natural water drive also enhances the prospect of excellent recovery over time.

No drilling was conducted on the Rinconada block during the late 2005 and early 2006 campaign due to rig availability. However, we remain enthusiastic about the shallow Sierras Blancas prospect on this block and will be evaluating it sometime in 2006. Success could mean a multiwell follow-up program at low cost with high density drilling spacing units to capitalize on attractive economic returns for a play of this type.



WITH SUCH A COMPELLING START, OUR CHALLENGE WILL BE TO CONSOLIDATE OUR SUCCESSSES INTO A RELIABLE AND STABLE PRODUCTION PROFILE IN ARGENTINA WHILE PURSUING NEW PROJECTS AND PREPARING PLANS FOR DRILLING IN PERU.



Argentine oil = 80% MX, 20% US

Outlook For 2006

In 2006 Petrolifera plans to install permanent facilities at Puesto Morales to enable more consistent and lower cost production of these excellent wells and any follow-up success deriving from the aggressive exploration and development program planned for the balance of the year.

An initial 2006 budget of \$31 million for Argentina has been established. This could be expanded if additional rigs become available. The company's financial forecast suggests that if Petrolifera chooses, it should have ample cash flow and cash balances to facilitate a more aggressive drilling campaign. An aggressive approach seems warranted by results to date and by our continuing interpretation of the data.

Approximately \$9.6 million of the 2006 budget has been allocated to facilities including gathering lines, storage tanks, a new treatment plant and a proposed 25 kilometer six-inch pipeline with initial throughput limited by the capacity of control valves, in the short-run. The

eventual capacity of this line should approach 20,000 bbl/d. These facilities are consistent with our goal of reaching approximately 13,500 bbl/d by year end 2006 and if warranted by new drilling results, pipelined oil could be supplemented by continued trucking to third party facilities to treat the oil before sale. The relevant material for these facilities has been ordered and design work and construction plans are well-advanced. Petrolifera wants to expand its facilities in a prudent and cost-effective manner until the ultimate reserves and productive capacity of the discoveries can be established. There is no shortage of trucking capacity in the region, which is a well-established oil producing area. Surface conditions are eminently manageable with limited vegetation or human population. Services and supplies in close proximity are available at nearby oil towns such as Catriel.

Our initial drilling plan for 2006 now involves 24 proposed wells on the Puesto Morales block, with 11 Sierras Blancas/Punta Rosada tests and 13 Quintuco tests. Certain of the Sierras Blancas wells are contingent on the outcome of other wells to be drilled. This program could also be expanded if additional drilling rigs and service rigs can be secured. We are presently advancing negotiations to secure one rig on a full-time basis for the next 18 months and a second rig for up to six months of swing-time drilling on the block, augmented of course with a dedicated service rig to enable testing and completion to occur on an immediate basis after drilling, logging and casing the proposed wells. It is also possible at least two wells could be drilled this year on the Rinconada block.

It now appears the Sierras Blancas and Punta Rosada prospects will be drilled up on an initial approximate 160-acre spacing basis, while we expect the numerous Quintuco wells will be drilled on planned 80-acre spacing and if successful, the shallower Sierras Blancas prospect at Rinconada would likely be drilled up on a 40-acre spacing basis. Given the large areal extent of the lands prospective for Quintuco reserves of both crude oil and natural gas on the concession, we expect drilling could continue for several years at an active pace before the region is fully developed.

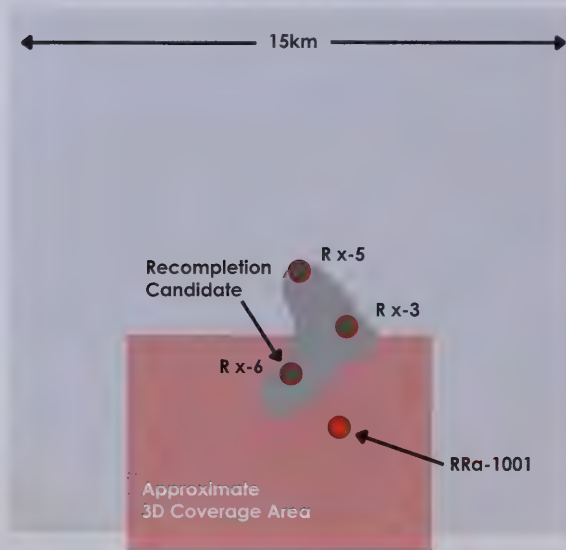


Fig. 6: Rinconada Block

The 2006 capital budget is anticipated to be financed from available cash balances and from forecast net operating income from Puesto Morales production. New exploration and production opportunities will be examined on a regular basis. Crude oil prices in Argentina are presently affected by a federal export tax, which has the effect of reducing domestic selling prices at the wellhead, whether or not the crude oil is destined for local or export markets. This sliding scale tax results in Petrolifera receiving approximately 68 percent of world price as the tax rate commences at a price of US\$32 per barrel and rises from 25 percent at this level to 45 percent at US\$45 per barrel and higher. In Canadian dollar terms, Petrolifera receives approximately \$45 per barrel at US\$60 for WTI, with the Canadian dollar equivalent to approximately \$0.87 US. With low operating costs associated with new prolific flowing oil wells, even while trucking to market currently, netbacks are sufficient to provide an attractive rate of return on investment at this time. Royalty rates are low at 12 percent and are payable to provincial authorities.

Petrolifera will continue to emphasize a low cost structure for both operations and administrative overhead. Our field operations are conducted by our operator on an efficient and effective basis pursuant to a recently negotiated two-year contract, so Petrolifera has the advantage of access to an established indigenous operator in touch with prevailing services and oilfield practices.

We believe 2006 should be the "year of expansion" of our reserve, production and revenue base in Argentina after experiencing the "year of discovery" in 2005.

PERU

Petrolifera entered Peru on the first business day of 2005 and by the end of the first week of the year had initiated an agreement in principle to secure two significant licenses covering over five million acres of prospective lands in two separate basins. This unprecedented development was accomplished with the financial backing and support of Connacher, the company's major shareholder. It reflects the commitment of management to seize opportunities of value in a timely manner and reflects management's understanding



Fig. 7: Peru Concession Map - Year End 2005

of the business conditions and the countries in which the company is now involved. In the case of Peru, Petrolifera capitalized on the accumulated expertise and experience of its senior executives, especially Gary Wine (before he actually became President), who, having worked in Peru for the five prior years, came to understand the potential, the process and the possibilities that could be secured for Petrolifera under the right circumstances. This included a timely application for new rights to capitalize on the forward-looking and constructive policy changes that had been introduced in the country.

These initiatives included: being able to negotiate new licenses without paying sizeable upfront cash bonuses, an important consideration for a relatively small company like Petrolifera; securing the data base at no significant cash cost to accelerate the ability to assess opportunities for new prospects and projects; new progressive and reasonable tax and royalty policies with tax rates established by Supreme Decree (the law of the land); an ability to secure world prices for crude oil with an attendant right to export, even though Peru at the time was a net importer of crude oil; arbitration, if required, in international courts; and a negotiated work program with reasonable financial guarantees that were considered manageable within Petrolifera's anticipated financial capacity and with Connacher's initial backstop guarantee.

It is now generally accepted by industry that Peru had revamped its policies to the point where their terms were ranked among the best if not the best on the continent. Following a week of discussion and negotiation, Petrolifera was able to initial a "heads of agreement" to secure two licenses as described herein. In March 2005, these awards were ratified by the board of Perupetro, the state agency charged with administering oil and natural gas rights in the country, followed by formal awards, by Supreme Decree, of licenses covering Block 106 in the Marañón Basin in July 2005 and of Block 107 in the Ucayali Basin in September 2005.

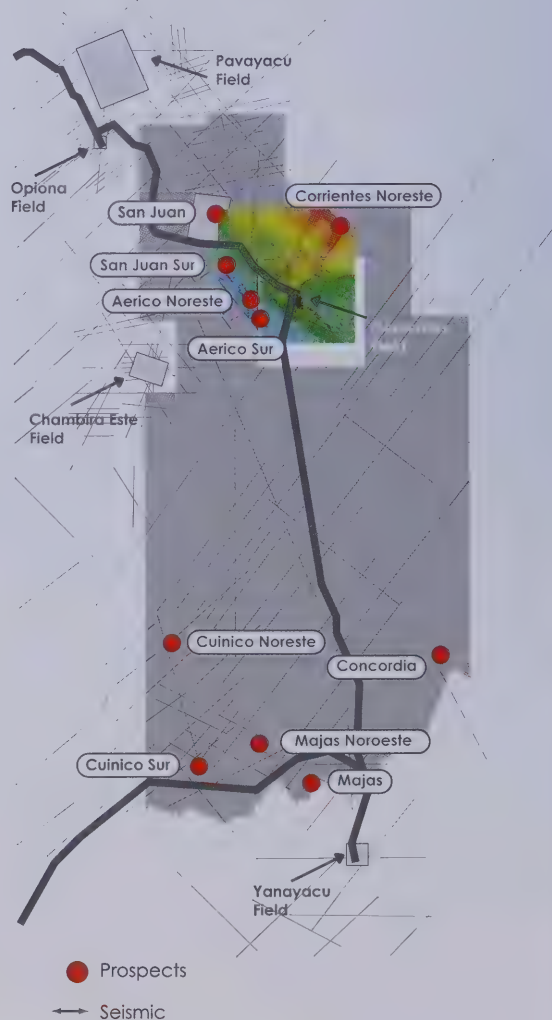
Block 106, Marañón Basin

The license covering Block 106 in the Marañón Basin was the first of two awarded to the company by Peru in 2005. We feel this is a major accomplishment for a company of Petrolifera's size and management is enthused about the significant reserve potential of the block.

Block 106 is comprised of 8,010 square kilometers (1,997,500 acres), which, by North American standards, is approximately 87 townships in size. This represents an area of some 70 miles by 45 miles. It surrounds the largest oil field in the Marañón Basin. This field, Corrientes, has been assigned recoverable reserves (based on public information as posted on the official website at www.perupetro.com.pe) of 218 million barrels of medium gravity crude oil. It is operated by a large South American independent company. A pipeline with significant spare capacity approaching 60,000

bbl/d crosses the block before it heads westward to market outlets at the shores of the Pacific Coast. Based on available data and geological studies, Petrolifera believes the block has significant reserve and resource potential.

Fig. 8: Marañón Block 106



Of consequence to the prospectivity of the Block is that it is also surrounded by a number of established oil fields which are filled to spill point. Wells drilled in or around the Block encountered excellent reservoirs indicating an attractive per well productivity should hydrocarbons be found. Also, the type of oil which Petrolifera expects to encounter is of sufficient quality to meet pipeline specifications without the necessity of any blending, unlike the heavier oil which has been encountered in the northeast Marañon Basin.

The primary objectives in the region are stacked multiple sandstone reservoirs of Cretaceous age. Well depths will be considerable at approximately 10,000 feet and the original well on a prospect in the region could cost up to US\$10 million, due to logistics associated with river access, helicopter support and jungle drilling. However, once a discovery is made, based on historical data and for planning purposes, it is expected follow-up well costs drilled from an established development pad would be considerably less, more likely in the range of US\$3 million to US\$4 million. Also, seismic costs would be much higher than experienced in Argentina, for example, because of the jungle environment.

In an independent study of the block conducted in 2005 by DeGolyer and MacNaughton Canada Limited ("D&M"), as of December 31, 2005, D&M recognized six drillable or mature prospects and four immature prospects on the Marañon Block. Immature prospects require additional seismic or other technical data to be upgraded to mature status. Significant unrisks reserve or resource potential was assigned by D&M to these prospects and leads.

Pursuant to the negotiated terms of the license over Block 106, Petrolifera is committed to a minimum work program of US\$2.2 million during the first three years of the primary seven-year term of the exploration license. This will require the company to post letters of credit for only US\$0.4 million, well within the company's financial capability. A firm drilling commitment does not arise until the fourth year of the license and the total commitment for the Block is US\$25.4 million. At the end of each of the second, third, fourth, fifth and sixth years, Petrolifera can abandon the license without further financial obligation. These are fair and reasonable terms which are eminently manageable by the company, without triggering the

need for partnering or joint ventures if Petrolifera chooses to explore and drill for its own account. Connacher retains a 10 percent carried working interest through the drilling and completion or abandonment of the first well on Block 106. This was granted in exchange for the corporate and other guarantees and support it provided Petrolifera to enable it to secure the block in the first instance. This interest is convertible, at Connacher's election, into a two percent gross overriding royalty. Petrolifera holds a right of first purchase of this interest. Petrolifera also awarded a three percent gross overriding royalty to Gary Wine in consideration of his expertise in assisting Petrolifera in securing this license. As with the Connacher interest this override is also subject to a right of first purchase in favour of Petrolifera.

Plans for 2006 include completion of mandatory baseline environmental studies and community liaison programs, to be followed by geological and geophysical studies and global positioning to properly locate old seismic lines and wells. Seismic programs will be initiated in early 2007 after the rainy season. This should help to control costs and facilitate superior data acquisition during the drier seasons. Petrolifera hopes to be in a position to drill its first well by late 2007, likely in the vicinity of the Corrientes field.

This significant block has sound potential for meaningful and sizeable crude oil discoveries. It is well-situated in relation to established production and infrastructure, which is normally unavailable in exploratory blocks in many less-developed countries throughout the world.

Petrolifera has benefited significantly from the high level of cooperation it has received from all officials within Perupetro in securing and administering this block. This includes cooperation in the realm of community relations to ensure indigenous people are aware of and educated about upcoming exploration activities, which might affect their lifestyle and economic activity. Petrolifera has been and intends to continue being a sound and responsive corporate citizen in Peru, especially when conducting activity in regions populated by indigenous persons and which are also in proximity to the headwaters of the Amazon River.

Block 107, Ucayali Basin

The license covering Block 107 in the Ucayali Basin, was awarded to Petrolifera in September 2005. The massive area comprising this Block covers an area of 13,000 square kilometers, or approximately 140 townships (30 miles by 170 miles) in North American terms. It runs along the Andes fold and thrust belt and, if superimposed on the map of Alberta, Canada, would run from the Montana border with Canada over 150 miles north beyond Calgary, Alberta in a strip about 30 miles wide. It is on trend with the Camisea complex to the southeast, has highway access (two separate roads) and has the potential for significant accumulations.

Importantly, this Block exposes Petrolifera to the potential discovery of huge natural gas and condensate discoveries similar in nature to Camisea. Attributed total reserves at Camisea have been estimated at 16 trillion cubic feet of natural gas and 850 million barrels of natural gas liquids, including condensate (see www.perupetro.com.pe). While geological and geophysical control over the Block is limited, management believes the block has the requisite geological conditions to find similar types of accumulations as well as more conventional prospects for both crude oil and natural gas in the foreland of the Ucayali Basin.

The Aguaytia natural gas field with reported reserves of 440 Bcf of natural gas and 20 million barrels of condensate and natural gas liquids is situated just east of the Block and currently produces approximately 65 mmcf/d and 4,400 bbl/d of liquids (see www.aguaytia.com). The gas is used for a cogeneration project while the liquids are shipped to a nearby refinery at Pucallpa in central eastern Peru.

Camisea to the south has been onstream for a short period of time after being developed by a consortium headed by a small Argentinean independent company which developed the field (originally discovered by a major oil company) and built a pipeline over the Andes to Lima and to the Pacific Ocean. Plans are proceeding for the construction of a US\$2.5 billion LNG plant to initially process 650 mmcf/d of Camisea

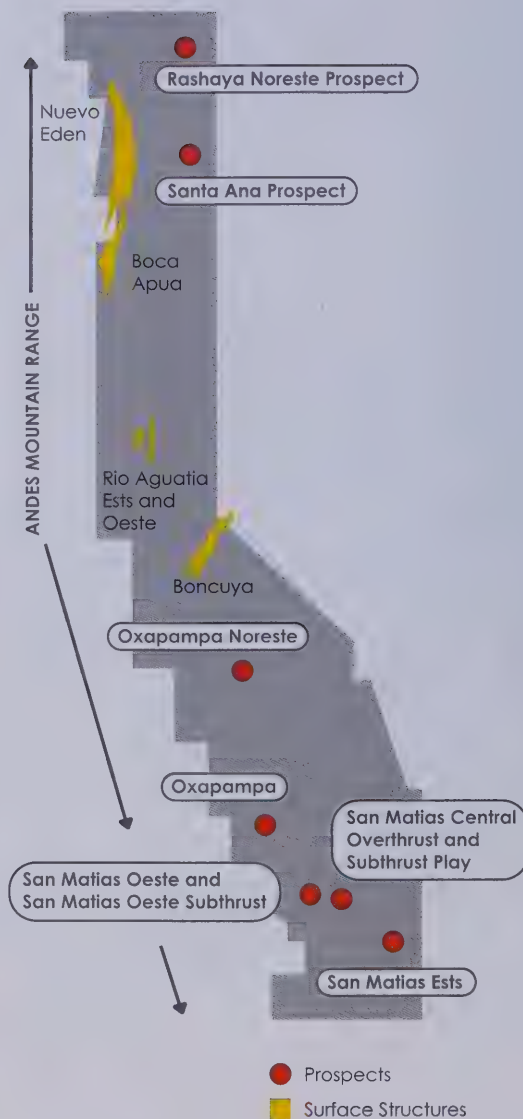


Fig. 9: Ucayali Block 107

natural gas for export to Mexico and other international markets. A further 150 mmcf/d of production is destined for Lima, which is being gassified to utilize natural gas. Additionally, discussions are evolving about building of a new pipeline from Peru to Chile to help alleviate the shortages Chile is experiencing due to shortfalls in the deliveries of Bolivian and Argentinean natural gas, for a variety of political and policy reasons. Peru is emerging as the hub for South American LNG and a prospective exporter of natural gas surplus to forecast domestic needs. As a result, the prospect of new exports and a strong economic framework is emerging, and the outlook for natural gas in Peru is considered attractive to assure new investment with a solid return on capital.

Block 107 has only had six wells drilled on it. All of these wells encountered hydrocarbon shows, which is important in confirming that there are active petroleum systems in the region, with adequate source and migration to facilitate the possibility of commercially-sized accumulations. Reservoirs are expected to be excellent with three active source rocks identified. Highway and river access are available. One of the wells drilled before any modern seismic was shot had a gas column of over 200 meters, tested gas to surface and is still reported to be leaking a minor amount of natural gas, after being abandoned by a previous operator in the 1960s.

The most modern seismic available to Petrolifera indicates the tectonic regime to find Camisea-like structures is present. Additionally, there are undrilled sizeable surface anticlines over which limited if any seismic has been shot. There are also undrilled structures close to production in the northern portion of the Block, which could lead to early cash flow to finance the longer-term drilling of fold and thrust belt structures with Camisea-like characteristics. In other words, this is a remarkably well-positioned but frontier Block which could have company-maker potential.

Petrolifera's work commitment, as negotiated with Perupetro, is reasonable, with US\$3.4 million of commitments with a US\$0.6 million guarantee for the first four years. There is no mandatory drilling until year seven, although as with Block 106, Petrolifera hopes to commence drilling at a much earlier date. The total

work commitment on the Block is US\$16.4 million. At the end of each of the second, fourth and sixth years, Petrolifera can abandon the license without further financial obligation. This is well within Petrolifera's current financial capacity, giving it the flexibility to decide on partnering or joint venturing. Connacher holds an identical 10 percent convertible carried working interest and Mr. Wine, the President, was also awarded a similar three percent override on this Block for his expertise and role in securing this license for Petrolifera with identical rights of first purchase as in Block 106.

D&M also assessed the potential of prospects and leads on Block 107 in their study of December 31, 2005. While D&M only assigned mature status to two prospects, primarily due to lack of extensive data, they did acknowledge eleven immature prospects, underscoring the prospectivity of the Block and its favorable geological positioning.

During 2006, Petrolifera intends to invest at least \$2.2 million in Peru on Blocks 106 and 107, for seismic reprocessing, environmental studies, and geophysical studies on Block 107. Additional global positioning work is contemplated and then a more expansive investment is likely in 2007 on both Blocks for extensive seismic programs in preparation for late-year drilling.

Since Petrolifera secured its Peruvian licenses, the price of crude oil appreciated markedly and set off a worldwide rush for new concessions, licenses or other forms of land tenure within the oil and gas industry. Peru was no exception, as much of the available onshore region in prospective sedimentary basins has now been secured by both large and small companies. Furthermore, Petrolifera has been approached by several large companies about possible joint venture negotiations. We are in a very favorable position in this regard, with 100 percent ownership and operatorship under our control.

We are continuing to monitor new opportunities and are actively pursuing some new possible arrangements to broaden our exposure in the country.

PRODUCTION AND RESERVES

PRODUCTION

During 2005, Petrolifera produced a total of 52,925 barrels of crude oil and 470 million cubic feet of gas, all in Argentina. Daily average production was 145 bbl/d of crude oil and 1,287 mcf/d of natural gas. On a boe basis, this equates to 360 boe/d using an energy equivalency conversion. The average price received for crude oil in 2005 was \$43.73 per barrel, with a peak of \$49.90 and a low of \$38.73 during the year. These prices reflect the impact of Argentina's export tax on crude oil which has the effect of limiting oil sales prices in the country. Natural gas prices, which are also regulated, only averaged \$0.93 per mcf, well below historic levels, due to the country's economic crisis earlier this decade.

Production was fairly stable throughout 2005 until the fourth quarter. At that time, a small portion of Petrolifera's significant new Puesto Morales crude oil productive capacity was placed onstream, having an initial limited impact on results. As a consequence, several days of production from the 1003 well and minor contributions from the 1004 well resulted in average daily sales in December of 748 bbl/d compared to only 133 bbl/d in the prior month. As a result, Petrolifera's exit rate for December 2005 was 965 boe/d comprised of the aforementioned oil volumes and 217 boe/d of natural gas sales.

Average daily production by quarter and for the full fiscal year was as follows:

2005 Average Daily Production

	Q1	Q2	Q3	Q4	FY
Oil and natural gas liquids (bbl/d)	85	86	84	324	145
Natural gas (mcf/d)	1,209	1,381	1,273	1,285	1,287
Total (boe)	287	316	296	538	360

Daily production in Argentina is currently in excess of 3,400 boe/d, primarily due to the impact of new sales from significant new crude oil discoveries made by the

company on its Puesto Morales block in the Neuquen Basin in 2005 and early 2006. Production continues to be constrained by available surface facilities required to process the oil. Until new facilities and a pipeline are in place, the crude oil is stored in single well batteries and then trucked to treatment plants owned by the company or by third parties. Once the crude is processed it is transported to market, again by truck.

As evidenced by the recent production levels, the company secured access, at a nominal cost, to similar underutilized facilities owned by another operator. This has permitted an additional 200 cubic meters of crude oil (approximately 1,250 bbl/d) to be treated and sold on a daily basis. Further discussions with a third operator are also proceeding, which could facilitate the incremental sale of approximately 1,000 cubic meters of crude oil per day (approximately 6,250 bbl/d) in addition to that currently being handled by the company and another operator as hereinbefore described. If these discussions come to fruition, this would enable Petrolifera to realize higher rates of production more quickly than originally planned.

Prior to the impact of new wells on Petrolifera's production levels in December, production in Argentina was essentially from stripper wells, with the exception of gas volumes from the PMN x-1 well. This situation has already dramatically changed with significant new volumes from different zones in newly-drilled and tested wells in the northern portion of the Puesto Morales Block.

The company's cost of production is likely to decline considerably relative to historical levels due to the spreading of fixed costs over much higher production volumes and eventual lowering of variable costs, such as for trucking, once the new proposed pipeline is operative later in 2006.



RESERVES

Crude Oil and Natural Gas Reserves - Argentina

The following is a summary of Petrolifera's crude oil and natural gas reserves in Argentina which comprise all of Petrolifera's reserves. The company does not own any reserves in Peru.

Reserves and Future Net Revenue - Argentina

DeGolyer and MacNaughton Canada Limited, independent petroleum engineers of Calgary, Alberta, ("D&M") was engaged to evaluate the company's crude oil and natural gas reserves and the value of future net revenue attributable to such reserves. D&M prepared an evaluation report dated March 20, 2006 with an effective date of December 31, 2005 (the "D&M Report"). All of the reserves assigned in the D&M Reports are located in the Puesto Morales/Rinconada Concession in Argentina. The D&M Reports were prepared using assumptions and methodology guidelines outlined in the Canadian Oil and Gas Evaluation Handbook ("COGE Handbook") and in accordance with NI 51-101.

All evaluations of future revenue contained in the D&M Reports are after the deduction of royalties, development costs, production costs and well abandonment costs but before consideration of indirect costs such as administrative, overhead and other miscellaneous expenses. The estimated future net revenues contained in the following tables do not necessarily represent the fair market value of the company's reserves. There is no assurance that the forecast price and cost assumptions contained in the D&M Report will be attained and variances could be material. Other assumptions and qualifications relating to costs and other matters are included in the notes to the tables. The recovery and reserves estimates of the company's properties described herein are estimates only. The actual reserves on the Petrolifera's properties may be greater or less than those calculated.

The following is a summary of the crude oil and natural gas reserves and the value of future net revenue of the company as at December 31, 2005 as evaluated by D&M. The pricing used in the forecast price evaluation is set forth in the notes to the tables.

Oil and Gas Reserves Based on Forecast Prices and Costs
December 31, 2005 ⁽⁸⁾

Reserve Category	Gross working interest remaining reserves ⁽¹⁾		Future cash flow		
	Light Crude Oil	Natural Gas	Undiscounted	Discounted	
				5%	10%
	stb	mmcf	\$000	\$000	\$000
Proved developed ⁽²⁾⁽⁵⁾					
Producing	4,174,060	1,394	148,450	133,002	120,859
Non-producing	664,319	996	4,781	2,567	276
Proved undeveloped ⁽²⁾⁽⁷⁾	1,171,638	409	37,177	31,317	26,611
Total proved ⁽²⁾	6,010,017	2,799	190,408	166,886	147,746
Probable ⁽³⁾	15,044,997	10,034	570,167	472,926	402,609
Total proved plus probable ⁽²⁾⁽³⁾	21,055,014	12,833	760,575	639,812	550,355
Possible ⁽⁴⁾	8,359,574	1,716	310,695	267,737	236,183
Total ⁽²⁾⁽³⁾⁽⁴⁾	29,414,588	14,549	1,071,270	907,549	786,538

Total Future Net Revenue (Undiscounted) Based On Forecast Prices And Costs
December 31, 2005 ⁽⁸⁾

(\$000)	Revenue	Royalties	Operating costs	Development costs	Abandonment and reclamation costs	Future net revenue before income taxes
Total Proved ⁽²⁾	276,721	37,357	31,906	16,253	797	190,408
Total Proved Plus Probable ⁽²⁾⁽³⁾	971,773	131,189	45,449	32,766	1,793	760,575
Total Proved Plus Probable Plus Possible ⁽²⁾⁽³⁾⁽⁴⁾	1,349,385	182,167	54,342	34,909	2,197	1,071,270

- (1) "Gross Reserves" are the Corporation's working interest (operating or non-operating) share before deducting of royalties and without including any royalty interests of the Corporation. "Net Reserves" are the Corporation's working interest (operating or non-operating) share after deduction of royalty obligations, plus the Corporation's royalty interests in reserves.
- (2) "Proved" reserves are those reserves that can be estimated with a high degree of certainty to be recoverable. It is likely that the actual remaining quantities recovered will exceed the estimated proved reserves.
- (3) "Probable" reserves are those additional reserves that are less certain to be recovered than proved reserves. It is equally likely that the actual remaining quantities recovered will be greater or less than the sum of the estimated proved plus probable reserves.
- (4) "Possible" reserves are those additional reserves that are less certain to be recovered than probable reserves. It is unlikely that the actual remaining quantities recovered will exceed the sum of the estimated proved plus probable plus possible reserves.
- (5) "Developed" reserves are those reserves that are expected to be recovered from existing wells and installed facilities or, if facilities have not been installed, that would involve a low expenditure (e.g. when compared to the cost of drilling a well) to put the reserves on production.
- (6) "Developed Producing" reserves are those reserves that are expected to be recovered from completion intervals open at the time of the estimate. These reserves may be currently producing or, if shut-in, they must have previously been on production, and the date of resumption of production must be known with reasonable certainty.
- (7) "Undeveloped" reserves are those reserves expected to be recovered from known accumulations where a significant expenditure (for example, when compared to the cost of drilling a well) is required to render them capable of production. They must fully meet the requirements of the reserves classification (proved, probable, possible) to which they are assigned.
- (8) The pricing assumptions used in the D&M Report with respect to net values of future net revenue (forecast) are set forth below and are as at December 31, 2005. D&M is an independent qualified reserves evaluator appointed pursuant to NI 51-101.

D&M Forecast Prices

Year Forecast	Light and Medium Crude Oil	Natural Gas
	Argentina Crude Oil Price (\$Cdn/bbl)	Argentina Gas Price (\$Cdn/mcf)
2006	46.81	1.53
2007	45.49	2.03
2008	42.36	2.06
2009	41.68	2.10
2010	42.51	2.14
2011	43.38	2.18
2012	44.25	2.21
2013	45.14	2.25
2014	46.06	2.30
2015	46.98	2.34
Thereafter	+2%	+2%

Future Development Costs - December 31, 2005

The following table sets forth the estimated future development costs, excluding abandonment costs, based upon the D&M Report.

(\$000)	Total Proved Estimated Using Forecast Prices and Costs	Total Proved Plus Probable Estimated Using Forecast Prices and Costs	Total Proved Plus Probable Plus Possible Estimated Using Forecast Prices and Costs
2006	13,375	24,825	29,938
2007	2,794	7,266	8,797
2008	-	79	79
2009	65	129	129
Total for all years undiscounted	16,253	32,766	39,409
Total for all years discounted at 10% per year	15,180	30,272	36,455

Petrolifera has or expects to have sufficient cash balances, internally generated cash flow from production and working capital to fund future development costs set out in the December D&M Report. Anticipated costs are primarily for drilling and completion of wells offsetting existing production and for facilities, including a pipeline. Estimated future abandonment costs are \$2.2 million (\$683,000 discounted at 10 percent per year).

Significant Factors or Uncertainties

The December D&M Report based on forecast prices and costs assumes that the price received for natural gas sales in Argentina will continue to improve above levels currently being received. The report forecasts that the price to be received will eventually exceed the levels in existence prior to the Argentinean economic collapse in 2001. Failure to do so would likely mean a deferral of proposed wells if the Corporation's sole objective was to discover new natural gas reserves. Most of Petrolifera's Argentinean prospects are multi-zone targeting both crude oil and natural gas. As such, it is unlikely activity would be unduly delayed for this reason.

Forecast Productive Capacity

The D&M Report forecasts the productive capacity of the Puesto Morales property by reserve category as follows:

- *Total Proved and Probable Reserves* – Gross production is forecast to reach 15,700 bbl/d of crude oil from 40 wells and 4.8 mmcf/d of associated natural gas and non-associated natural gas from three wells, both in 2007, after expenditures of approximately \$32 million for wells and facilities, including an oil pipeline.
- *Total Proved, Probable and Possible Reserves* – Gross production is forecast to reach 24,800 bbl/d of crude oil from 50 wells and 6.5 mmcf/d of associated natural gas and non-associated natural gas from three wells after expenditures of approximately \$39 million for new wells and facilities, including an oil pipeline.

2005 Year End Reserve Reconciliation — Net of Royalties ⁽¹⁾⁽²⁾⁽³⁾

(mboe)	Proved	Probable	Possible	Total
At December 31, 2004	539	453	277	1,269
Discoveries	4,090	13,717	1,220	18,027
Revisions of prior estimates	1,088	290	5,982	7,360
Acquisitions	-	-	-	-
Dispositions	-	-	-	-
Production	(115)	-	-	(115)
At December 31, 2005	5,602	14,460	7,478	27,541

(1) May not add due to rounding

(2) Calculated based on forecast price case as at December 31, 2005.

(3) All references to barrels of oil equivalent (boe) are calculated on the basis of 6 mcf: 1 bbl.

During 2005, Petrolifera's net proved reserves increased 940 percent to 5.6 million boe, primarily due to new discoveries. Meanwhile, the company's proved and probable reserves increased 1,922 percent, or over 19 times to 20.1 million boe. Petrolifera's proved, probable and possible reserves increased by 21 times to 27.5 million boe.

Petrolifera's proved plus probable reserves are forecast to generate an undiscounted future revenue stream of \$760 million with a 10 percent pre-tax present worth after deduction of royalties, operating costs and future capital of \$550 million. Present worth values are not necessarily representative of fair market values and fluctuate depending upon various factors, including price schedules developed by independent evaluators.

Properties with No Attributed Reserves - Peru

In 2005, Petrolifera was awarded licenses to explore for crude oil and natural gas in two blocks covering over five million acres in two basins in Peru. Block 106, in the Marañón Basin, is comprised of approximately two million acres. It surrounds a large crude oil field in the area and is surrounded by other producing crude oil fields as well as being bisected by an underutilized pipeline. Block 107 in the Ucayali Basin is comprised of approximately three million acres and is on trend with the Camisea field in Peru.

Prospective Resources - Peru

Petrolifera engaged the services of D&M to evaluate the prospective resources of certain prospects located on Block 106 in the Marañón Basin and Block 107 on the Ucayali Basin in Peru. Their evaluation was originally contained in a report dated August 23, 2005 (the "Peru D&M Report") which has been updated to an effective date of December 31, 2005. As the report only deals with quantities, time value of money does not enter into the reporting, and no value-altering work was done on the Blocks subsequent to award and prior to December 31, 2005. Prospective resources are those quantities of petroleum that are estimated, as of a given date, to be

potentially recoverable from undiscovered accumulations. As a result of the lack of commerciality or sufficient exploration drilling, the prospective resources estimated and included in the Peru D&M Report cannot be classified as reserves pursuant to NI 51-101.

The Peru D&M Report includes a description of both mature prospects and immature prospects, with the distinction between these subcategories of prospects being the current stage of technical evaluation. The different stages of technical evaluation relate to the amount of geologic, geophysical, engineering and petrophysical data, as well as the quality of available data. A mature prospect is a potential accumulation that is sufficiently well defined to be a viable drilling target. For a mature prospect, sufficient data and analyses exist to identify and quantify the technical uncertainties, determine reasonable ranges of geologic chance factors, engineering and petrophysical parameters, and estimate prospective resources. An immature prospect is less well defined and requires additional data and/or evaluation to be classified as a mature prospect. An immature prospect may or may not be elevated to mature prospect status depending on the results of additional technical work.

The key conclusions of the Peru D&M Report are as follows:

- A total of eight mature prospects were identified:
 - Six on Block 106 in the Marañon Basin; and
 - Two on Block 107 in the Ucayali Basin.
- Sixteen additional immature prospects were identified:
 - Four on Block 106 in the Marañon Basin; and
 - Twelve on Block 107 in the Ucayali Basin.
- Prospective petroleum resources have only been assigned to the mature prospects.
- Should the mature prospects result in successful discoveries and development, estimates of the gross prospective oil resources before the assignment of geological risk are as follows:

(mmbbl)	Low Estimate ⁽¹⁾⁽²⁾⁽³⁾	Best Estimate ⁽¹⁾⁽²⁾⁽³⁾	High Estimate ⁽¹⁾⁽²⁾⁽³⁾
Gross Prospective Crude Oil Resources ⁽⁴⁾	81,407	176,640	289,147

- (1) Low, best and high estimates follow the Society of Petroleum Engineers, World Petroleum Congresses and the American Association of Petroleum Geologists guidelines for prospective resources. The resource range presented above is valid in the event of successfully finding hydrocarbons in each and every prospect. In this case, the possible range of recoverable resources would likely lie in the range between the low estimate and the high estimate.
- (2) The low estimate reported is the P90 quantity derived from probabilistic analysis. This means that there is at least a 90 percent probability that, assuming the prospect is discovered and developed, the quantities actually recovered will equal or exceed the low estimate. The high estimate is the P10 quantity. This means that there is at least a 10 percent probability that, assuming the prospect is discovered and developed, the quantities actually recovered will equal or exceed the high estimate. The best estimate is based upon the expected value, based upon the outcome of a probabilistic analysis.
- (3) The probability of geological success as estimated by D&M was applied to the best estimate shown above, which is defined as the probability of discovering reservoirs which flow petroleum at a measurable rate, have not been applied to the quantities shown in the above estimates. If the probability of geological success was applied to the best estimate shown above, the gross prospective resources would be 19,862 mmbbl.
- (4) Gross resources are defined as the total estimated petroleum that is potentially recoverable after December 31, 2005.

There can be no assurance that the prospects identified in the Peru D&M Report will be developed or will result in successful discoveries and the timing of drilling of these prospects is uncertain. Petrolifera has committed to a work program in respect of both Block 106 and Block 107, but drilling of the first well on each of these blocks is not required pursuant to these work programs until at least 2009 in respect of Block 106 and 2012 in respect of Block 107.

MANAGEMENT'S DISCUSSION & ANALYSIS

The following is dated as of March 21, 2006 and should be read in conjunction with the consolidated financial statements of Petrolifera Petroleum Limited ("Petrolifera" or the "company") for the years ended December 31, 2005 and 2004 as contained in this annual report. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are presented in Canadian dollars. This MD&A provides management's view of the financial condition of the company and the results of its operations for the reporting periods. Information in the report contains forward-looking information based on current expectations, estimates and projections of future production, capital expenditures and available sources of financing. It should be noted forward-looking information involves a number of risks and uncertainties and actual results may vary materially from those anticipated by the company. These risks and uncertainties include, but are not limited to, political and economic conditions in the countries in which the company operates, changes in market conditions, law or governing policy, operating conditions and costs, operating performance, demand for crude oil and natural gas, foreign currency exchange rate fluctuations, currency controls, commercial negotiations and technical and economic factors. Throughout the MD&A, per barrel of oil equivalent (boe) amounts have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil (6:1). The conversion is based on an energy equivalency conversion method primarily applicable to the burner tip and does not represent a value equivalency at the wellhead. Boe and may be misleading particularly if used in isolation.



RICHARD R. KINES
Chief Financial Officer

CORPORATE OVERVIEW

	2005	2004 ⁽¹⁾
FINANCIAL (\$C000s except per share amounts)		
Total revenue	2,864	123
Cash flow from operations before working capital changes ⁽²⁾	434	12
Per share, basic ⁽²⁾	0.02	-
Per share, diluted ⁽²⁾	0.01	-
Net loss	(415)	(26)
Per share, basic and diluted	(0.02)	-
Capital expenditures	6,662	41
Cash on hand	19,744	159
Working capital	17,887	92
Indebtedness	-	2,750
Shareholders' equity	27,060	414
Total assets	31,581	3,884
OPERATING		
Daily production / sales volumes		
Crude oil - bbl/d	145	82
Natural gas - mcf/d	1,287	1,165
Barrels of oil equivalent - boe/d ⁽³⁾	360	276
Reserves (mboe) ⁽³⁾		
Proved	6,477	556
Probable	16,717	468
Possible	8,645	287
Total	31,839	1,311
Prices		
Oil - \$/bbl	43.73	38.28
Natural gas - \$/mcf	0.93	0.72
Barrels of oil equivalent - \$/boe ⁽³⁾	20.93	14.38
Common shares outstanding (000s)		
Weighted average		
Basic	20,721	8,830
Diluted	31,803	8,830
End of period		
Issued	34,404	13,000
Fully diluted	51,118	18,350

(1) For the period from the date of incorporation on November 9, 2004 to December 31, 2004.

(2) Cash flow from operations before working capital changes and cash flow per share do not have standardized meanings prescribed by Canadian generally accepted accounting principles ("GAAP") and therefore may not be comparable to similar measures used by other companies. Cash flow from operations before working capital changes includes all cash flow from operating activities and is calculated before changes in non-cash working capital. The most comparable measure calculated in accordance with GAAP would be net earnings. Cash flow from operations before working capital changes is reconciled with net earnings on the Consolidated Statement of Cash Flows and in the accompanying Management's Discussion & Analysis. Management uses these non-GAAP measurements for its own performance measures and to provide its shareholders and investors with a measurement of the company's efficiency and its ability to fund a portion of its future growth expenditures.

(3) The reserve estimates for 2005 and 2004 were prepared by an independent professional petroleum engineering firm in accordance with National Instrument 51-101 (NI 51-101). Under NI 51-101, proved reserve assignments are based on a 90 percent certainty that total quantities received will equal or exceed proved reserve estimates. Proved plus probable reserves are the most likely case and are based on a 50 percent certainty that they will equal or exceed estimates. Proved plus probable plus possible reserves have a 10 percent probability that they will equal or exceed estimates.

(4) No dividends have been declared by the company since its incorporation.

During the 14 months since incorporation Petrolifera's management has concentrated on building a financially strong company with a diversified asset base.

To this end, the company completed three equity financings, two by way of private placement and one by way of initial public offering pursuant to a prospectus dated October 17, 2005. The company's common shares and the warrants offered in conjunction with the initial public offering were listed for trading on the Toronto Stock Exchange under the symbol PDP and PDP.WT, respectively, on November 8, 2005.

During 2005 Petrolifera completed a \$6.7 million capital program which included a 3D seismic program and the drilling of five successful oil wells in Argentina and the acquisition of two oil and natural gas exploration licenses covering blocks comprised of over five million acres in two separate basins onshore Peru.

The company's recent drilling program in Argentina was very successful and including early 2006 drilling had resulted in six oil wells, five of which have significant productive capacity. As interim arrangements to treat produced crude oil are completed, production growth is expected to be considerable in 2006. Plans are also underway to install new permanent treatment facilities and a 25 kilometer six-inch pipeline to connect to market, thereby reducing the amount of the light gravity crude oil to be trucked and treated by third party operators prior to sale.

Petrolifera's financial condition was strengthened considerably during 2005 and its asset base and financial results were directionally much improved, while not yet fully reflecting the success in drilling results achieved near year end. The company's growth is anticipated to further accelerate in 2006.

FINANCIAL AND OPERATING REVIEW

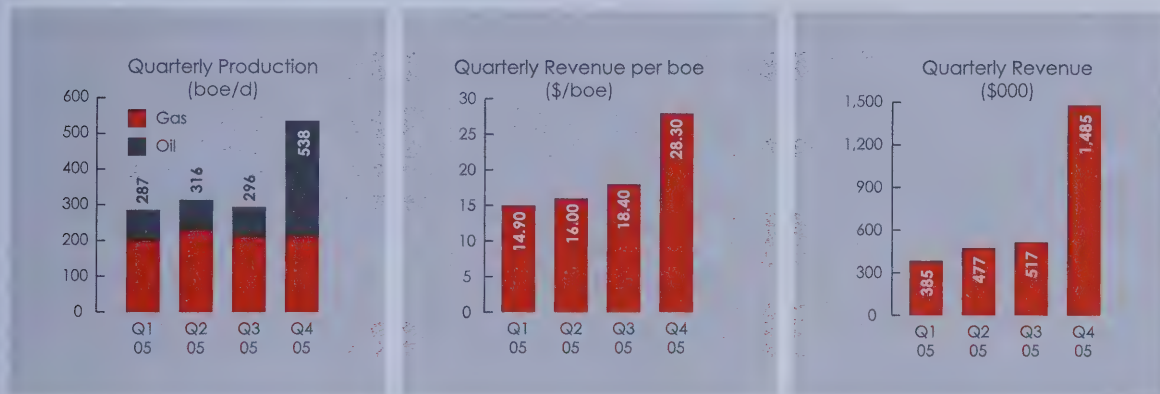
PRODUCTION, PRICING AND REVENUE

	Year Ended December 31, 2005	From Incorporation to December 31, 2004
Daily production / sales volumes		
Oil – bbl/d	145	82
Natural gas – mcf/d	1,287	1,165
Total – boe/d	360	276
Product pricing (\$)		
Oil – per bbl	43.73	38.28
Natural gas – per mcf	0.93	0.72
Revenue per boe	20.93	14.38
Petroleum and natural gas sales (\$)	2,750,110	122,973
Interest and other income	114,098	-
Total revenue	2,864,208	122,973

Petroleum and natural gas revenues for 2005 were \$2.8 million on sales of 145 bbl/d of crude oil and 1,287 mcf/d of natural gas. All production is from the company's Argentinean properties. Crude oil and natural gas production remained stable for the first nine months of 2005. New discoveries in late 2005 resulted in fourth quarter production rising to 538 boe/d and December 2005 sales of crude oil were 965 bbl/d. Argentinean crude oil selling prices averaged \$43.73 per barrel, reflecting world prices for that quality of crude oil and Argentinean pricing policies and export taxes, which limited the realized price. The average Argentinean natural gas price of \$0.93 per mcf is

substantially below North American standards, reflecting regulated pricing in Argentina. Natural gas prices have been improving and are expected to continue improving in the future due to market conditions and new policy initiatives aimed at market deregulation.

Interest and other income was \$114,000 in 2005 and nil for the 2004 reporting period and relates to interest earned on short-term cash deposits.



ROYALTIES

Royalties represent charges against production or revenue by governments and landowners. Royalties in 2005 were \$353,000 (\$2.68 per boe), or 13 percent of oil and gas revenue.

In the 2004 reporting period, royalties were \$16,000, \$1.87 per boe or 13 percent of oil and gas revenues.

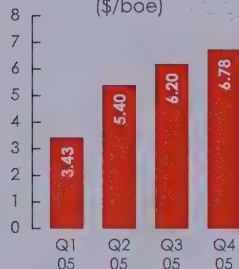
OPERATING EXPENSES AND NETBACKS

Company Netbacks (1)

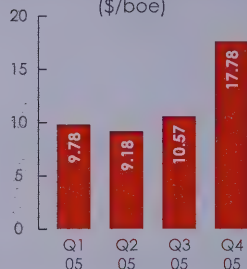
	Year ended 2005		Period from incorporation to December 31, 2004	
	Total	Per boe	Total	Per boe
Average daily production (boe/d)	360		276	
Petroleum and natural gas sales	\$2,750,110	\$20.93	\$122,973	\$14.38
Interest and other income	114,098	0.86	-	-
Royalties	(352,712)	(2.68)	(15,986)	(1.87)
Net revenue	2,511,496	19.11	106,987	12.51
Operating costs	(748,809)	(5.70)	(41,449)	4.85
Corporate netback	\$1,762,687	\$13.41	\$65,538	\$7.66

- (1) Calculated by dividing related revenue and costs by total boe produced, resulting in an overall company netback. Netbacks do not have a standardized meaning prescribed by GAAP and therefore may not be comparable to similar measures used by other companies. Nevertheless, Petrolifera's management uses netbacks as a performance measurement of operating efficiency and the prevailing royalty regime. A high ratio of netback to selling price is a positive indicator.

Operating Expenses per boe
(\$/boe)



Company Netback per boe
(\$/boe)



Petrolifera's netbacks improved approximately 75 percent over those recorded in the 2004 reporting period. This reflects a 46 percent increase in the boe selling price and interest income from cash balances, which offset higher royalties due to the improved product prices for both crude oil and natural gas.

2005 Operating Netbacks by Product

For the year ended December 31, 2005

Per unit netbacks are calculated by dividing netbacks by sales volumes.

Operating netbacks by product type are indicated below.

	Crude oil		Natural gas	
	Total	Per bbl	Total	Per mcf
Average daily production	145 bbl/d		1,287 mcf/d	
Petroleum and natural gas sales	\$2,314,581	\$43.73	\$435,529	\$0.93
Royalties	(296,854)	(5.61)	(55,858)	(0.12)
Operating costs	(630,222)	(11.91)	(118,587)	(0.25)
Field operating netback	\$1,387,505	\$26.21	\$261,084	\$0.56

Operating costs in 2005 were stable for most of the year, although declines became evident later in the year as new volumes were realized, and fixed costs were allocated over a broader base. Crude oil production was from mature wells for most of the year and operating costs reflected this until the fourth quarter when new flowing oil wells were placed onstream.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative ("G&A") expenses were \$921,000 in 2005, reflecting costs incurred in Canada, Argentina and Peru. These costs primarily consist of management and advisory fees, insurance, the cost of independent reserve reports, travel and other administrative expenses. G&A of \$164,000 was capitalized in 2005 (2004 - \$nil) and non-cash stock-based compensation costs of \$124,000 were recorded in the year (2004 - \$nil), reflecting the fair value of all stock options granted and vested in the year. The increase from 2004 is attributable to increased staffing, costs as a public company and a full year of operations.

FINANCING CHARGES AND FOREIGN EXCHANGE

Finance charges of \$77,000 were expensed in 2005, relating to interest on a promissory note due to Connacher Oil and Gas Limited ("Connacher"), a related company. The note was discharged during the year.

When translating foreign denominated financial statements and operating results, the impact of fluctuations on the Argentinean peso relative to the Canadian dollar resulted in a foreign exchange gain of \$131,000 in 2005. The company's main exposure to foreign currency risk relates to the pricing of crude oil sales, costs and capital expenditures which are denominated in US dollars and Argentinean pesos.

DEPLETION, DEPRECIATION AND ACCRETION ("DD&A")

DD&A is calculated using the unit-of-production method based on total estimated proved reserves. DD&A in 2005 was \$826,000 or \$6.29 per boe. This includes a charge of \$25,000 to accrete the company's estimated asset retirement obligation. These charges will continue to be necessary in future to accrete the currently booked discounted liability of \$467,000 to the estimated total undiscounted liability of \$751,000 over the estimated remaining economic life of the company's oil and gas properties.

Capital costs of \$780,000 related to a major development project principally related to Peruvian assets in a pre-production state have been excluded from depletable costs. No proved reserves have yet been assigned to this project. Future development costs of \$16.3 million for proved undeveloped reserves were included in the depletion calculation.

CEILING TEST

Oil and gas companies are required to compare the recoverable value of their oil and gas assets to their recorded carrying value at the end of each reporting period. Excess carrying values over fair value are to be written off against earnings. No write-down was required in 2005 or in 2004.

TAXES

The current income tax provision of \$330,000 for 2005 (2004 - \$nil), relates to income taxes in Argentina. Additionally, a future tax provision of \$30,000 for the year was recorded to recognize the changes in tax pool balances.

NET EARNINGS AND SHARES OUTSTANDING

	Year ended December 31, 2005		Period from incorporation until December 31, 2004	
	Total	Per boe	Total	Per boe
Netback	\$1,762,687	\$13.41	\$65,538	\$7.66
General & administrative	(921,133)	(7.01)	38,752	(4.53)
Stock-based compensation	(124,415)	(0.95)	-	-
Finance charges	(77,333)	(0.59)	(14,863)	(1.74)
Foreign exchange gain	130,823	1.00	1,429	0.17
Depletion, depreciation and accretion	(826,231)	(6.29)	(56,025)	(6.55)
Income tax recovery (provision)	(359,600)	(2.73)	17,100	2.00
Net loss for the period	\$(415,202)	\$(3.16)	\$(25,573)	\$(2.99)

In 2005 the company reported a loss of \$415,000, which equates to \$0.02 per basic and \$0.01 per diluted share outstanding.

For 2005, the weighted average number of common shares outstanding was 20,721,430. Due to a loss in the year, no incremental shares were included for the diluted per share calculations because the effect would be anti-dilutive.

As at March 21, 2006, the company had the following securities issued and outstanding:

- 37,075,445 common shares;
- 11,982,197 common share purchase warrants;
- 2,219,200 stock options; and
- 546,000 broker compensation warrants

Details of the exercise rights and terms of the warrants and options are noted in the Consolidated Financial Statements, included in this Annual Report.

LIQUIDITY AND CAPITAL RESOURCES

Cash flow from operations before working capital changes ("cash flow"), cash flow per share and cash flow per boe do not have standardized meanings prescribed by GAAP and therefore may not be comparable to similar measures used by other companies. Cash flow includes all cash flow from operating activities and is calculated before changes in non-cash working capital. The most comparable measure calculated in accordance with GAAP would be net earnings. Cash flow is reconciled with net earnings on the Consolidated Statement of Cash Flows and below. Cash flow per share is calculated by dividing cash flow by the weighted average shares outstanding; cash flow per boe is calculated by dividing cash flow by the quantum of crude oil and natural gas (expressed in boe) sold in the period. Management uses these non-GAAP measurements for its own performance measures and to provide its shareholders and investors with a measurement of the company's efficiency and its ability to fund a portion of its future growth expenditures.

Reconciliation of net loss to cash flow from operations before working capital changes:

	Year ended December 31, 2005	Period from incorporation until December 31, 2004
Net loss for the period	\$(415,202)	\$(25,573)
Add (deduct)		
Stock-based compensation	124,415	-
Depletion, depreciation, and accretion	826,231	56,025
Future income tax provision (recovery)	29,600	(17,100)
Foreign exchange gain	(130,823)	(1,429)
Cash flow from operations before working capital changes	\$434,221	\$11,923

Cash flow from operations in 2005 was \$434,000 (\$0.02 per basic share and \$0.01 per diluted share).

Capital expenditures in 2005 totaled \$6.7 million primarily for seismic expenditures and costs to drill five oil wells in Argentina and for new projects in Peru.

FINANCING ACTIVITIES

In March 2005, the company completed a \$7 million private placement financing consisting of seven million common shares and 3.5 million common share purchase warrants. Proceeds of the financing were used as follows:

	As stated at the time of the financing	As actually applied
Gross proceeds	\$7,000,000	\$7,000,000
Agent commissions and issue costs	(779,000)	(747,000)
Applied to reduce promissory note payable to Connacher	(2,000,000)	(2,000,000)
Used in the capital program	\$4,221,000	\$4,253,000

In November 2005 the company completed a \$21.3 million public offering, by way of prospectus, consisting of 12,193,894 units each comprised of one common share and one-half share purchase warrant, with one warrant and \$3.00 entitling the holder to acquire one additional common share from treasury until May 8, 2007. Proceeds of the financing were used as follows:

	As stated in the Prospectus at time of Financing	As actually applied
Gross proceeds	(up to) \$30,000,000	\$21,339,000
Agent commissions and issue costs	(up to) (2,360,000)	(1,797,000)
PowerOne success fee	(up to) (550,000)	(327,000)
Repayment of promissory note and accrued interest	(817,500)	(817,500)
Available for capital program	\$26,272,500	\$18,397,500

Management believes that available cash, together with proceeds from the exercise of outstanding share purchase warrants and cash flow from operations before working capital changes, are expected to provide sufficient funding for working capital purposes and for the company's anticipated capital program in 2006.

The company's only financial instruments are accounts receivable and payable; it maintains no off-balance sheet financial instruments.

RELATED PARTY TRANSACTIONS AND SIGNIFICANT TRANSACTIONS

In 2005 certain contracts were entered into with related parties. A summary of the features of each of these agreements is noted below.

Under the terms of a Management Services Agreement with Connacher, Connacher provides all management, operational, accounting and general and administrative services necessary or appropriate to manage and administer the company. The fee for this service was \$10,000 per month prior to Petrolifera's equity securities being listed and posted for trading on the Toronto Stock Exchange and \$15,000 per month until May 2007. The agreement may be immediately terminated for performance failure by the aggrieved party, or upon 30 days prior written notice by Connacher, or by mutual agreement. From time to time Connacher also pays bills on behalf of Petrolifera, for which it is reimbursed.

In consideration for the assistance provided to Petrolifera in securing two crude oil and natural gas exploration licenses in Peru and for the provision of financial guarantees respecting Petrolifera's annual work commitments in the licensed blocks in 2005, Connacher was granted an option to acquire 200,000 common shares at \$0.50 per share and was granted a 10 percent carried working interest ("CWI") through the drilling of the first well on each block. Petrolifera has the right of first purchase of this interest should Connacher elect to sell it at some future date. The CWI is convertible at the holder's election into a two percent gross overriding royalty on each license after the drilling of the first well on each license. These interests became effective upon the issuance of the licenses. The guarantees are limited to amounts specified over the terms of the licenses. Over the next 24 months, the guarantee is limited to US \$200,000. Connacher was subsequently indemnified by Petrolifera for this guarantee.

In consideration for his expertise and role in assisting the company in securing the two licenses in Peru, an officer of the company received options to purchase 300,000 Common Shares at a price of \$0.50 per share, exercisable until February 1, 2010, a single payment of \$100,000 and pursuant to an overriding royalty agreement with the company, was granted a three percent gross overriding royalty ("GORR") on each of the two Peruvian blocks. The GORR will vest over three years; one-third vested immediately upon the issuance of the licenses, one-third will vest one year thereafter and the remaining one-third will vest two years after the issuance of the licenses. The company has the right of first purchase of the GORR at fair value should the officer elect to sell it at some future date.

In consideration for his expertise and role in assisting the company in securing the two licenses in Peru, another officer of the company received options to purchase 300,000 Common Shares at a price of \$0.50 per share, exercisable until February 1, 2010 and a success fee of \$20,000 upon the closing of the March 2005 private placement financing and a success fee of \$40,000 in November 2005 upon the company completing its initial public offering ("IPO") financing.

To assist in marketing the March 2005 private placement financing, the company retained PowerOne Capital Markets Limited ("PowerOne") as one of the selling agents. Prior to the March 2005 private placement financing,

PowerOne was considered a connected issuer of Petrolifera because, together with its officers, directors and shareholders and associates of such persons, it owned 18 percent of the outstanding shares of the company. PowerOne received a commission for its services.

In March 2005, a Consulting Agreement with PowerOne was extended to November 2006 with a monthly fee of \$6,000.

An additional success fee ("PowerOne Success Fee") in the amount of \$326,786 was paid to PowerOne upon the company completing its IPO in November 2005.

In March 2005 the term to repay the balance of the Promissory Note to Connacher was extended to March 12, 2006. The balance owing plus accrued interest was repaid on November 8, 2005.

In March 2005 the company granted Connacher the right, without obligation, to participate in future financings to maintain its 40 percent equity interest in Petrolifera.

The company has entered into an executive employment agreement with Gary D. Wine with an effective date of March 11, 2005. Under the terms of this agreement, Mr. Wine is entitled to a base salary as determined by the Human Resources Committee of the board of directors, an annual bonus which is based upon the achievement of certain targets relating to corporate performance and stock options as granted by the board of directors from time to time. The term of the agreement is indefinite. The agreement may be terminated by the company without notice or cause upon the payment of 18 months annual base salary plus one and a half times the average amount of the bonus payments paid to Mr. Wine for the two calendar years prior to the date of termination, plus the sum of \$15,000, less applicable withholdings and deductions, representing compensation for the loss of benefits and perquisites (the "Termination Payment"). In the event of a "change of control", as defined in the agreement, Mr. Wine will also be entitled to the Termination Payment. The executive employment agreement also contains standard confidentiality and non-disclosure provisions.

SIGNIFICANT ACCOUNTING POLICIES AND APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

The significant accounting policies used by the company are described below. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Changes in these judgments and estimates may have a material impact on the company's financial results and condition. The following discusses such accounting policies and is included in the MD&A to aid the reader in assessing the critical accounting policies and practices of the company and the likelihood of materially different results being reported. Management reviews its estimates regularly. The emergence of new information and changed circumstances may result in changes to estimates which could be material and the company might realize different results from the application of new accounting standards promulgated, from time to time, by various rule-making bodies.

The following assessment of significant accounting policies is not meant to be exhaustive.

Oil And Gas Reserves

Under Canadian Securities Regulators' "National Instrument 51-101-Standards of Disclosure for Oil and Gas Activities" ("NI 51-101") proved reserves are those reserves that can be estimated with a high degree of certainty to be recoverable. In accordance with this definition, the level of certainty should result in at least a 90 percent

probability that the quantities actually recovered will equal or exceed the estimated reserves. In the case probable reserves, which are less certain to be recovered than proved reserves, NI 51-101 states that it must be equally likely that the actual remaining quantities recovered will be greater or less than the sum of the estimated proved plus probable reserves. Possible reserves are those reserves less certain to be recovered than probable reserves. There is at least a 10 percent probability that the quantities actually recovered will exceed the sum of proved plus probable plus possible reserves.

The oil and gas reserve estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the company's plans. The reserve estimates are also used in determining the company's borrowing base for its credit facilities and may impact the same upon revision or changes to the reserve estimates. The effect of changes in proved oil and gas reserves on the financial results and position of the company is described under the heading "Full Cost Accounting for Oil and Gas Activities".

FULL COST ACCOUNTING FOR OIL AND GAS ACTIVITIES

Depletion Expense

The company uses the full cost method of accounting for exploration and development activities. In accordance with this method of accounting, all costs associated with exploration and development are capitalized whether successful or not. The aggregate of net capitalized costs and estimated future development costs less estimated salvage values is amortized using the unit-of-production method based on estimated proved oil and gas reserves.

Major Development Projects and Unproved Properties

Certain costs related to major development projects and unproved properties are excluded from net capitalized costs subject to depletion until proved reserves have been determined or their value is impaired. These costs are reviewed quarterly and any impairment is transferred to the costs being depleted or, if the properties are located in a cost centre where there is no reserve base, the impairment is charged directly to income.

Full Cost Accounting Ceiling Test

The company is required to review the carrying value of all property, plant and equipment, including the carrying value of oil and gas assets, for potential impairment. Impairment is indicated if the carrying value of the long-lived asset or oil and gas cost centre is not recoverable by the future undiscounted cash flows. If impairment is indicated, the amount by which the carrying value exceeds the estimated fair value of the long-lived asset is charged to earnings.

The ceiling test is based on estimates of reserves, production rate, petroleum and natural gas prices, future costs and other relevant assumptions. By their nature these estimates are subject to measurement uncertainty and the impact on the consolidated financial statements could be material.

Asset Retirement Obligations

The company is required to provide for future removal and site restoration costs by estimating these costs in accordance with existing laws, contracts or other policies. These estimated costs are charged to earnings and

the appropriate liability account over the expected service life of the asset. When the future removal and site restoration costs cannot be reasonably determined, a contingent liability may exist. Contingent liabilities are charged to earnings only when management is able to determine the amount and the likelihood of the future obligation. The company estimates future retirement costs based on current estimates adjusted for inflation and credit risk. These estimates are subject to management uncertainty.

Income Taxes

The company follows the liability method of accounting for income taxes. Under this method tax assets are recognized when it is more than likely realization will occur. Tax liabilities are recognized for temporary differences between recorded book values and underlying tax values. Rates used to determine asset and liability amounts are rates in future periods when the timing differences change. The period in which a timing difference reverses are impacted by future income and capital expenditures. Rates are also affected by legislation changes. These components can impact the charges to future income for taxes.

Stock-Based Compensation

The company uses the fair value method to account for stock options. The determination of the amounts for stock-based compensation are based on assumption of stock volatility, interest rates and the term of the option. Assumptions by their nature are subject to measurement uncertainty.

Legal, Environment Remediation and Other Contingent Matters

In respect of these matters, the company is required to determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine if such a loss can be estimated. When any such loss is determined, it is charged to earnings. Management continually monitors known and potential contingent matters and makes appropriate provisions by charges to earnings when warranted by circumstance.

IMPACT OF NEW ACCOUNTING PRONOUNCEMENTS

There are no new accounting pronouncements which are expected to impact the consolidated financial statements of the company going forward.

COMMITMENTS, CONTINGENCIES AND GUARANTEES

In 2005 Petrolifera acquired two significant oil and gas exploration licenses in Peru. The licenses have a total US\$41.8 million financial commitment to complete negotiated work programs on the two licenses over seven years. The Company has the right to withdraw from the licenses at the end of each period associated with the term of the licenses.

In 2005 the company issued letters of credit in the amount of US\$200,000 to secure the capital expenditure requirements associated with the first work program on two exploration licenses in Peru.

The Company's annual commitments under management, consulting and operating agreements are as follows:

2006 - \$900,000; 2007 - \$694,000; 2008 – nil; 2009 - nil; thereafter - nil.

Additionally, the company has various guarantees and indemnifications in place in the ordinary course of business, none of which are expected to have a significant impact on the company's financial statements or operations.



CONTROL CERTIFICATION

Petrolifera has designed disclosure controls and procedures to provide reasonable assurance that material information related to the company is included in the company's annual filings. Additionally, Petrolifera has evaluated the effectiveness of the company's disclosure controls and procedures as of the end of the filing period of December 31, 2005 and concluded that these controls are effective.

BUSINESS RISKS

Petrolifera is exposed to certain risks and uncertainties inherent in the oil and gas business. Furthermore, being a smaller independent company, it is exposed to financing and other risks which may impair its ability to realize on its assets or to capitalize on opportunities which might become available to it. Additionally, Petrolifera operates in various jurisdictions and is exposed to other risks including currency fluctuations, political risk, price controls and varying forms of fiscal regimes or changes thereto which may impair Petrolifera's ability to conduct profitable operations.

The risks arising in the oil and gas industry include price fluctuations for both crude oil and natural gas over which the company has limited control; risks arising from exploration and development activities; production risks associated with the depletion of reservoirs and the ability to market production. Additional risks include environmental and safety concerns.

The company relies on access to capital markets for new equity to supplement internally generated cash flow and bank borrowings to finance its growth plans. Periodically, these markets may not be receptive to offerings of new equity from treasury, whether by way of private placement or public offerings. This may be further complicated by the limited market liquidity for shares of smaller companies, restricting access to some institutional investors. An increased emphasis on flow-through share financings may accelerate the pace at which junior oil and gas companies become cash-taxable, which could reduce cash flow available for capital expenditures on growth projects. Periodic fluctuations in energy prices may also affect lending policies of the company's banker, whether for existing loans or new borrowings. This in turn could limit growth prospects over the short run or may even require the company to dedicate cash flow, dispose of properties or raise new equity to reduce bank borrowings under circumstances of declining energy prices or disappointing drilling results.

The success of the company's capital programs as embodied in its productivity and reserve base could also impact its prospective liquidity and pace of future activities. Control of finding, development, operating and overhead costs per boe is an important criterion in determining company growth, success and access to new capital sources.

The company attempts to mitigate its business and operational risk exposures by maintaining comprehensive insurance coverage on its assets and operations, by employing or contracting competent technicians and professionals, by instituting and maintaining operational health, safety and environmental standards and procedures and by maintaining a prudent approach to exploration and development activities. The company also addresses and regularly reports on the impact of risks to its shareholders, writing down the carrying values of assets that may not be recoverable.

Furthermore, the company generally relies on equity financing and a bias towards conservative financing of its operations under normal industry conditions to offset the inherent risks of domestic and international oil and gas exploration, development and production activities. In the past the company has entered into forward sale,



fixed price contracts to mitigate reduced product price risk and foreign exchange risk during periods of price improvement, primarily with a view to assuring the availability of funds for capital programs and to enhance the creditworthiness of its assets with its lenders. While hedging activities may have opportunity costs when realized prices exceed hedged pricing, such transactions are not meant to be speculative and are considered within the broader framework of financial stability and flexibility. Management continuously reviews the need to utilize such financing techniques.

OUTLOOK

The company's business plan contemplates aggressive growth. To accomplish this, the company expects an active capital program of oil and gas exploration and development drilling in Argentina in 2006 and in Peru commencing in 2007.

Forecast operating cash flow from growing production and available cash should finance Petrolifera's expected 2006 capital spending program, which has been initially established at \$33 million. All capital program expenditures are discretionary, except for a total of \$US1 million for which the company is committed during 2006 and 2007, by the Peruvian exploration licenses.

All estimates and statements which may have been issued are forward-looking statements. This involves inherent risks and uncertainties where actual results will differ and such differences could be material. There can be no assurance that Petrolifera will achieve the drilling results and levels of production it might assume in developing its internal capital budget and financial plan. In addition, oil and gas prices are subject to fluctuation and there can be no assurance that the prices assumed for the company's internal plan, or any variation thereof, will be attained.

QUARTERLY RESULTS

	2004	2005			
	From incorporation on November 9, 2004 to December 31	Three months ended			
		Mar 31	June 30	Sept 30	Dec 31
Financial results					
(\$000s except per share amounts) – unaudited					
Total revenue	123	385	477	517	1,485
Cash flow from operations before working capital changes	12	73	77	56	228
Basic, per share ⁽¹⁾	-	-	0.01	-	0.01
Diluted, per share ⁽¹⁾	-	-	0.01	-	0.01
Earnings (loss) for the period	(26)	(75)	(161)	5	(184)
Basic, per share	-	-	(0.01)	-	(0.01)
Diluted, per share	-	-	(0.01)	-	(0.01)
Capital expenditures	41	1,295	245	650	4,472
Cash on hand	159	3,420	3,237	2,315	19,744
Working capital surplus	92	3,112	2,222	44	17,887
Indebtedness	2,750	750	750	750	-
Shareholders' equity	414	6,881	6,738	6,766	27,060
Total assets	3,884	8,688	8,530	9,251	31,581
Operating results					
Production / sales volumes					
Crude oil – bbl/d	82	85	86	84	324
Natural gas – mcf/d	1,165	1,209	1,381	1,273	1,285
Equivalent – boe/d ⁽²⁾	276	287	316	296	538
Pricing					
Crude oil – \$/bbl	38.28	39.83	44.84	48.01	43.08
Natural gas – \$/mcf	0.72	0.72	0.86	1.12	0.99
Selected highlights – \$/boe ⁽²⁾					
Weighted average sales price	14.38	14.91	15.97	18.46	28.31
Interest and other income	-	-	0.61	0.51	1.67
Royalties	1.87	1.70	2.00	2.22	3.85
Operating costs	4.85	3.43	5.40	6.20	6.78
Netback ⁽³⁾	7.66	9.78	9.18	10.57	17.78
Common share information (000s)					
Shares outstanding at end of period	13,000	20,000	20,000	20,000	34,404
Fully diluted	18,350	30,140	30,140	31,080	51,118
Weighted average shares outstanding for the period					
Basic	8,830	14,633	20,000	20,000	20,721
Diluted	8,830	18,309	23,676	23,676	31,803

- (1) Cash flow from operations before working capital changes ("cash flow") and cash flow per share do not have standardized meanings prescribed by Canadian generally accepted accounting principles ("GAAP") and therefore may not be comparable to similar measures used by other companies. Cash flow from operations before working capital changes includes all cash flow from operating activities and is calculated before changes in non-cash working capital. The most comparable measure calculated in accordance with GAAP would be net earnings. Cash flow from operations before working capital changes is reconciled with net earnings on the Consolidated Statement of Cash Flows and in the accompanying Management's Discussion & Analysis. Management uses these non-GAAP measurements for its own performance measures and to provide its shareholders and investors with a measurement of the company's efficiency and its ability to fund a portion of its future growth expenditures.

- (2) All references to barrels of oil equivalence (boe) are calculated on the basis of 6 mcf : 1 bbl. Boe may be misleading particularly if used in isolation. This conversion is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalent at the wellhead.

- (3) For detailed netbacks by product type, see "Operating Expenses and Netbacks" in the accompanying MD&A.

CONSOLIDATED
FINANCIAL
STATEMENTS

MANAGEMENT'S REPORT

To the Shareholders of Petrolifera Petroleum Limited:

The consolidated financial statements of Petrolifera Petroleum Limited were prepared by and are the responsibility of management. The consolidated financial statements have been prepared in conformity with Canadian generally accepted accounting principles appropriate in the circumstances and include some amounts that are based on management's best estimates and judgments. Information contained elsewhere in the Annual Report is consistent, where applicable, with information contained in the financial statements.

The company maintains systems of internal accounting controls designed to provide reasonable assurance that all transactions are properly recorded in the company's books and records, that policies and procedures are adhered to and that the assets are protected from unauthorized use. The systems of internal accounting controls are complemented by the selection, training and development of qualified staff. Management believes that the system of internal controls that the company has installed has operated effectively in 2005.

The consolidated financial statements have been audited by the independent accounting firm Deloitte & Touche LLP whose appointment is ratified annually by the shareholders at the annual shareholders' meeting. The independent accountants perform such tests and related procedures as they deem necessary to arrive at an opinion on the fairness of the financial statements.

The audit committee of the board of directors periodically meets with the independent accountants and management to satisfy itself that it is properly discharging its responsibilities. The independent accountants have unrestricted access to the audit committee, without management present, to discuss the results of their examination and the quality of financial reporting and internal accounting controls.

Signed, _____ Signed,

"R.A. Gusella"

Executive Chairman

March 21, 2006

"R. R. Kines"

Interim Chief Financial Officer

March 21, 2006

AUDITORS' REPORT

To the Shareholders of Petrolifera Petroleum Limited:

We have audited the consolidated balance sheets of Petrolifera Petroleum Limited as at December 31, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the year ended December 31, 2005 and for the period from incorporation on November 9, 2004 to December 31, 2004. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2005 and 2004 and the result of its operations and its cash flows for the year ended December 31, 2005 and for the period from incorporation on November 9, 2004 to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

Signed,

Calgary, Alberta

March 21, 2006

"DELOITTE & TOUCHE LLP"

Chartered Accountants

CONSOLIDATED BALANCE SHEETS

Petrolifera Petroleum Limited
December 31

	2005	2004
	\$	\$
ASSETS		
Current		
Cash and cash equivalents	19,743,842	159,224
Accounts receivable	2,060,464	199,841
Prepaid expenses	136,197	30,856
	21,940,503	389,921
Future income tax asset (Note 4)	940,500	675,100
Property and equipment (Note 5)	8,699,795	2,818,925
	31,580,798	3,883,946
LIABILITIES		
Current		
Accounts payable	3,832,688	190,917
Due to a related company (Note 10)	221,131	106,843
	4,053,819	297,760
Asset retirement obligations (Note 6)	467,100	422,171
Promissory note due to a related company (Note 7)	-	2,750,000
	4,520,919	3,469,931
SHAREHOLDERS' EQUITY		
Share capital, warrants and contributed surplus (Note 8)	27,239,821	1,433,136
Deficit	(179,942)	(1,019,121)
	27,059,879	414,015
	31,580,798	3,883,946

Commitments, contingencies and guarantees (Note 12)

Approved by the board

Signed,
"C.J. Smith"
Director

Signed,
"D.D. Barkwell"
Director

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

Petrolifera Petroleum Limited
Periods Ended December 31

	2005	2004
	\$	\$
		(Note 1)
REVENUE		
Petroleum and natural gas sales	2,750,110	122,973
Other income	114,098	-
	2,864,208	122,973
Royalties	(352,712)	(15,986)
	2,511,496	106,987
EXPENSES		
Operating	748,809	41,449
General and administrative	921,133	38,752
Stock-based compensation	124,415	-
Finance charges	77,333	14,863
Foreign exchange gain	(130,823)	(1,429)
Depletion, depreciation and accretion	826,231	56,025
	2,567,098	149,660
Loss before income taxes	(55,602)	(42,673)
Current income tax provision	330,000	-
Future income tax provision (recovery)	29,600	(17,100)
	359,600	(17,100)
NET LOSS	(415,202)	(25,573)
DEFICIT, BEGINNING OF PERIOD	(1,019,121)	-
Elimination of deficit (Note 8(f))	1,254,381	-
Related party transaction (Note 10)	-	(993,548)
DEFICIT, END OF PERIOD	(179,942)	(1,019,121)
LOSS PER SHARE (Note 11)		
Basic and diluted	(\$0.02)	\$0.00

CONSOLIDATED STATEMENTS OF CASH FLOWS

Petrolifera Petroleum Limited
Periods Ended December 31

	2005	2004
	\$	\$
		(Note 1)
CASH PROVIDED BY (USED IN) THE FOLLOWING ACTIVITIES:		
OPERATING		
Net loss	(415,202)	(25,573)
Items not involving cash:		
Depletion, depreciation and accretion	826,231	56,025
Stock-based compensation	124,415	-
Foreign exchange gain	(130,823)	(1,429)
Future income tax provision (recovery)	29,600	(17,100)
Cash flow from operations before working capital changes	434,221	11,923
Changes in non-cash working capital	(703,753)	64,623
	(269,532)	76,546
FINANCING		
Issue of common shares, net of share issue costs	26,641,639	1,373,336
Repayment of promissory note	(2,750,000)	(1,250,000)
	23,891,639	123,336
INVESTING		
Development of oil and gas properties	(6,662,189)	40,658
Changes in non-cash working capital	2,624,700	-
	(4,037,489)	(40,658)
INCREASE IN CASH AND CASH EQUIVALENTS	19,584,618	159,224
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	159,224	-
CASH AND CASH EQUIVALENTS, END OF PERIOD	19,743,842	159,224

SUPPLEMENTARY INFORMATION – NOTE 11

NOTES TO THE FINANCIAL STATEMENTS

Petrolifera Petroleum Limited

Periods Ended December 31, 2005 and December 31, 2004

1. INCORPORATION

Petrolifera Petroleum Limited ("Petrolifera" or the "company") was incorporated on November 9, 2004. Through subsidiaries and a foreign branch, it is engaged in petroleum and natural gas exploration, development and production activities in South America.

On November 26, 2004, Petrolifera acquired from its then parent company, Connacher Oil and Gas Limited ("Connacher") all of Connacher's Argentinean petroleum and natural gas properties. As consideration for these assets, Petrolifera issued to Connacher a \$4 million Promissory Note and 8 million common shares from treasury. For accounting purposes, as the fair value of the properties equaled the value of the Promissory Note, no value was ascribed to the common shares issued to Connacher. This transaction was considered to be a non-cash transaction and therefore was excluded from being reported on the Statement of Cash Flows in 2004. Also, as the transaction was between related parties and did not result in a substantive change in ownership of the properties transferred, the value assigned to the properties acquired by Petrolifera was limited to Connacher's carrying value of \$2.4 million. Consequently, the difference between the \$4 million fair value of the consideration paid and the \$2.4 million value assigned to the assets acquired, after future taxes of \$0.6 million, resulted in a \$994,000 charge to the Deficit at December 31, 2004.

Operating revenues and expenses from the producing oil and gas properties acquired have been recorded from November 26, 2004, the date the purchase transaction was closed.

On November 26, 2004, Petrolifera issued 5 million Units at \$0.30 per Unit to raise \$1.5 million gross proceeds in a private placement financing transaction (Note 8(a)). On November 26, 2004, Petrolifera utilized a portion of the financing proceeds to pay down \$1,250,000 of the Promissory Note. See also Note 7.

2. FINANCIAL STATEMENT PRESENTATION

The financial statements include the accounts of the company and its subsidiaries and are presented in Canadian dollars and in accordance with Canadian Generally Accepted Accounting Principles.

3. SIGNIFICANT ACCOUNTING POLICIES

Cash and cash equivalents

Cash and cash equivalents includes short-term deposits with initial maturities of three months or less.

Petroleum and natural gas operations

The company follows the full cost method of accounting whereby all costs relating to the exploration for and development of crude oil and natural gas reserves are capitalized on a country by country cost centre basis.

Capitalized costs of petroleum and natural gas properties and related equipment within a cost centre are depleted and depreciated using the unit-of-production method based on estimated proved crude oil and natural gas reserves as determined by independent consulting engineers. For the purpose of this calculation, production and reserves of natural gas are converted to equivalent units of crude oil based on relative energy content (6:1).

The company applies a "ceiling test" to the net book value of petroleum and natural gas properties to ensure that such carrying value does not exceed the estimated fair value of the properties. The carrying value is assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost and market of unproved properties exceeds the carrying value. If the carrying value is assessed to not be recoverable, the calculation compares the carrying value to the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties. Should the carrying value exceed this sum, an impairment loss is recognized. The cash flows are estimated using projected future product prices and costs and are discounted using the credit adjusted risk-free interest rate.

Costs of acquiring and evaluating unproved properties and major development projects are excluded from costs subject to depletion and depreciation until it is determined whether or not proved reserves are attributable to the properties or impairment occurs. These costs are reviewed quarterly and any impairment is transferred to the costs being depleted or, if the properties are located in a cost centre where there is no reserve base, the impairment is charged directly to income.

Gains or losses on sales of properties are recognized only when crediting the proceeds to cost would result in a change of 20 percent or more in the depletion and depreciation rate.

Financial instruments

Financial instruments include accounts receivable, accounts payable, amount due to a related company and the Promissory Note. All carrying values of financial instruments approximate fair values due to their short-term maturities.

Credit risk

The majority of the accounts receivable is in respect of oil and gas operations. The company generally extends unsecured credit to customers and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions. Management believes the risk is mitigated by the size and reputation of the companies to which credit has been extended.

Commodity risk and interest rate risk

The company is exposed to fluctuations in commodity prices and interest rates and has no contracts in place to mitigate these exposures.

Foreign operations

The company is exposed to foreign currency fluctuations, political risks, price controls and varying forms of fiscal regimes or changes thereto which may impair its ability to conduct profitable operations as it operates internationally and holds foreign denominated cash and other assets.

Foreign currency translation

Business conducted in Argentina and Peru is considered to be "integrated foreign operations" for accounting purposes and, therefore, their financial statements are translated into Canadian dollars using the temporal method. The company translates its foreign denominated monetary assets and liabilities at the exchange rate prevailing at year end. Non-monetary assets, liabilities and related depletion and depreciation are translated at historic rates. Revenues and expenses are translated at the average rate of exchange for the period. Any resulting foreign exchange gains or losses are included in operations.



Asset retirement obligations

The company provides for the costs of retirement obligations associated with long-lived assets, including the abandonment of oil and natural gas wells, related facilities, compressors and gas plants, removal of equipment from leased acreage and returning such land to its original condition. The estimated fair value of each asset retirement obligation is recorded in the period a well or related asset is drilled, constructed or acquired. Fair value is estimated using the present value of the estimated future cash outflows to abandon the asset using the company's credit adjusted risk-free interest rate and expected inflation rate. The obligation is reviewed regularly by management based upon current regulations, costs, technologies and industry standards. The discounted obligation is initially capitalized as part of the carrying amount of the related oil and natural gas properties and a corresponding liability is recognized. The liability is accreted against income until it is settled or the property is sold and is included as a component of depletion and depreciation expense. The increase in oil and natural gas properties is depleted and depreciated on the same basis as the remainder of the oil and natural gas properties. Actual restoration expenditures are charged to the accumulated obligation as incurred.

Revenue recognition

Petroleum and natural gas sales are recognized as revenue at the time the respective commodities are delivered to purchasers.

Stock-based compensation

The company uses the fair value method for valuing stock option grants. Compensation costs attributed to share options granted are measured at fair value at the grant date and expensed over the vesting period with a corresponding increase to contributed surplus. Upon exercise of the stock options, consideration paid by the option holder together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

Income taxes

The company follows the liability method of accounting for income taxes. Under this method, income tax liabilities and assets are recognized for the estimated tax consequences attributed to differences between the amounts reported in the financial statements and their respective tax bases, using substantively enacted income tax rates. The effect of a change in income tax rates on future income tax liabilities and assets is recognized in income in the period that the change occurs. Future tax assets are recognized when realization is probable and are assessed by management at each balance sheet date.

Measurement uncertainty

The timely preparation of the financial statements in conformity with Canadian generally accepted accounting principles requires that management make estimates and assumptions and use judgment regarding the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Such estimates primarily relate to unsettled transactions and events as of the date of the consolidated financial statements. Accordingly, actual results may differ from estimated amounts as future confirming events occur.

Amounts recorded for depreciation, depletion and accretion, amounts used for ceiling test and impairment calculations and amounts used in the determination of the future tax asset are based on estimates of natural gas and crude oil reserves and future costs required to develop those reserves. By their nature, these estimates of reserves, including the estimates of future prices and costs, and the related future cash flows are subject to measurement uncertainty.

Per share amounts

Basic per share amounts are calculated using the weighted average number of common shares outstanding for the period. The company follows the treasury stock method to calculate diluted per share amounts. The treasury stock method assumes that any proceeds from the exercise of in-the-money stock purchase warrants and other dilutive instruments would be used to purchase common shares at the average market price during the period.

4. INCOME TAXES

The following table reconciles income taxes calculated at the Canadian statutory rate with recorded income taxes:

Periods ended December 31	2005	2004
	\$	\$
Loss before income taxes	55,602	42,673
Statutory income tax rate	37.90%	39.10%
Expected income tax recovery	21,100	17,100
Non taxable items		
Non deductible expenditures and foreign taxes	(365,500)	-
Stock compensation	(47,200)	-
Rate adjustment	32,000	-
Tax (expense) recovery	(359,600)	17,100

Future tax assets relate to the following temporary timing differences:

	2005	2004
	\$	\$
Property and equipment	597,500	627,100
Operating losses	179,500	-
Share issue costs	1,210,000	48,000
	1,987,000	675,100
Valuation allowance	(1,046,500)	-
Net future tax asset	940,500	675,100

The company has only recognized a portion of its future tax asset related to share issue costs. At December 31, 2005 the company had non-capital losses of \$180,000 available to be carried forward for deduction against future taxable income. These losses do not expire before 2013.

5. PROPERTY AND EQUIPMENT

	Cost \$	Accumulated Depletion and Depreciation \$	Net Book Value \$
2005			
Petroleum and natural gas properties and equipment	9,489,474	835,036	8,654,438
Furniture, equipment and leaseholds	67,246	21,889	45,357
	9,556,720	856,925	8,699,795
2004			
Petroleum and natural gas properties and equipment	2,874,950	56,025	2,818,925

Included in property and equipment are estimated future asset retirement costs of \$427,332 (2004 - \$407,734). In 2005, the company capitalized \$164,046 (2004 - \$nil) of general and administrative expenses related to exploration and development activities.



Capital costs of \$779,566 related to major development projects principally related to Peruvian assets in a pre-production state have been excluded from depletable costs. No proved reserves have been assigned to those projects. The company began reviewing projects in Peru in 2005.

Depletion, depreciation and accretion expense includes a charge of \$25,330 (2004 - \$nil) to accrete the company's estimated asset retirement obligations (Note 6).

The ceiling test as at December 31, 2005 excludes \$779,566 of major development projects which have been separately evaluated by management for impairment. Based on the ceiling test and other assessments, no impairment has been recorded at December 31, 2005 or 2004.

Petrolifera's petroleum and natural gas reserves were evaluated by independent reservoir engineers as at December 31, 2005 in a report dated March 20, 2006. The evaluation was conducted in accordance with Canadian Securities Administrators' National Instrument 51-101 ("NI 51-101"), using the following price assumptions:

	Crude Oil Price (\$/bbl)	Natural Gas Price (\$/mcf)
2006	46.81	1.53
2007	45.49	2.03
2008	42.36	2.06
2009	41.68	2.10
2010	42.51	2.14
	+ approximately 2% thereafter	+ approximately 2% thereafter

6. ASSET RETIREMENT OBLIGATIONS

At December 31, 2005 the estimated total undiscounted amount required to settle the asset retirement obligations was \$751,080 (2004 - \$633,000). These obligations are expected to be settled over the useful lives of the underlying assets, which currently extend up to 20 years into the future. This amount has been discounted using a credit-adjusted risk-free interest rate of six percent and an annual inflation rate of 1.5 percent. Accretion expense of \$25,330 was recorded during the year ended December 31, 2005, no accretion expenses was recorded in 2004 as the amount calculated was nominal.

Changes to asset retirement obligations were as follows:

Period ended December 31	2005	2004
	\$	\$
Asset retirement obligations, beginning of period	422,171	-
Liabilities incurred	50,874	422,171
Changes in estimates	(31,275)	-
Accretion expense	25,330	-
Asset retirement obligations, end of period	467,100	422,171

7. PROMISSORY NOTE

As described in Note 1, the company issued a \$4 million Promissory Note to Connacher in November 2004. The Promissory Note was repayable from proceeds of planned future financings. It did bear interest at the bank's prime lending rate plus one percent and was secured by a general security agreement providing a floating charge and general assignment over the company's assets. The company repaid \$1.25 million in November 2004, repaid \$2 million in March 2005, and repaid the final \$750,000 together with accumulated interest in November 2005.

8. SHARE CAPITAL, WARRANTS AND CONTRIBUTED SURPLUS

Authorized

The authorized share capital is comprised of an unlimited number of common shares.

Issued:

	Number of Shares	Amount \$
Share capital:		
Issued on incorporation	1	1
Issued to acquire assets (Note 1)	8,000,000	-
Issued for cash by private placement (a)	5,000,000	1,500,000
Share issue costs		(126,665)
Tax effect of share issue costs		48,000
Balance share capital, December 31, 2004	13,000,001	1,421,336
Issued for cash by private placement (b)	7,000,000	7,000,000
Issued upon exercise of rights (c)	700,000	-
Issued for cash by initial public offering (d)	12,193,894	19,629,707
Issued upon exercise of warrants	1,510,000	1,365,000
Assigned value of broker compensation warrants exercised		6,551
Share issue costs		(3,084,077)
Tax effect of share issue costs		295,000
Elimination of deficit (f)		(1,254,381)
Balance share capital, December 31, 2005	34,403,895	25,379,137
Warrants		
Issued in initial public offering in 2005 (d)		1,709,608
Contributed surplus:		
Assigned value of broker compensation warrants issued in 2004 (a)		11,800
Assigned value of broker warrants issued in March 2005 (b)		21,400
Exercise of warrants in 2005		(6,551)
Assigned fair value of stock options granted in 2005 (g)		124,427
Balance, contributed surplus, December 31, 2005		151,076
Total share capital, warrants and contributed surplus:		
December 31, 2004		1,433,136
December 31, 2005		27,239,821



(a) Private Placement - 2004

In November 2004, Petrolifera issued five million Investor Units for gross proceeds of \$1.5 million. As partial compensation for distributing the Investor Units, selling agents were issued 350,000 Broker Compensation Warrants, each exercisable at a price of \$0.30 to acquire a maximum of 350,000 Broker Units. Each Investor Unit and each Broker Unit comprised one common share and one common share Purchase Warrant, each exercisable at \$0.40 per share to acquire a total of 5,350,000 common shares. See (e)(i) and (e)(ii) below.

For accounting purposes a fair value of \$11,800 was assigned to the Broker Compensation Warrants. The common share Purchase Warrants were determined to have no assignable fair value using the Black-Scholes option-pricing model.

(b) Private Placement – 2005

In March 2005 Petrolifera issued 7 million Units for gross proceeds of \$7 million. Each Unit comprised one common share, one-half of one common share Purchase Warrant and one Right. Each common share Purchase Warrant issued is exercisable at \$1.50 per share to acquire a total 3,500,000 common shares. See (e)(iii) below.

In addition, as partial compensation for distributing the Units, selling agents were issued 490,000 Broker Compensation Warrants. Each Broker Compensation Warrant is exercisable at a price of \$1.00 to acquire a maximum of 490,000 Broker Units. Each Broker Unit comprised one common share and one-half of one common share Purchase Warrant. See (e)(iv) below.

For accounting purposes, the common share Purchase Warrants issued were determined to have no assignable fair value using the Black-Scholes option-pricing model. The Broker Compensation Warrants issued had an assignable fair value of \$21,400, as calculated using the Black-Scholes option-pricing model.

(c) Rights - 2005

Each Right issued to investors in the March 2005 Private Placement financing entitled the holder to receive, without any further action or consideration, an additional 0.1 of a Unit, excluding a Right, for each Unit held in the event that the company had not, before October 11, 2005, either received a receipt for a final prospectus relating to an initial public offering of securities by a securities commission in at least one of the provinces of British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, or Nova Scotia; or completed a share exchange, amalgamation or other business combination resulting in shareholders of the company becoming holders of securities of an entity that is a reporting issuer in at least one of the provinces of British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, or Nova Scotia (herein defined as a "going public transaction").

For accounting purposes, the Rights were determined to have no assignable fair value using the Black-Scholes option-pricing model. Rights were not attached to the Broker Units issuable to the selling agents exercising their Broker Compensation Warrants.

On October 11, 2005, 700,000 common shares and 350,000 common share Purchase Warrants were issued pursuant to the Rights. See (e)(iii) below.

(d) Initial Public Offering – 2005

On November 8, 2005 the company issued 12,193,894 Units for total gross proceeds of \$21,339,315. Each Unit consisted of one common share and one-half of one common share Purchase Warrants (6,096,947 in total), with each whole common share Purchase Warrant entitling the holder to purchase one common share from treasury at a price \$3.00 at any time before May 8, 2007. Pursuant to this financing, the company listed its common shares and the warrants attached to the Units issued November 8, 2005 for trading on the Toronto Stock Exchange. See note (e)(v) below.

For accounting purposes, the common share Purchase Warrants had an assignable fair value of \$1,709,608 as calculated using the Black-Scholes option-pricing model.

(e) Warrants

As at December 31, 2005 the company had warrants outstanding to purchase common share as follows:

- (i) As to 5,000,000 common share Purchase Warrants issued in November 2004 – 4,250,000 shares at \$0.40 per share until October 17, 2008;
- (ii) As to 350,000 Broker Compensation Warrants issued in November 2004 – 350,000 common shares at \$0.30 per share until October 17, 2008;
- (iii) As to 3,500,000 common share Purchase Warrants issued in March 2005 and the 350,000 common share Purchase Warrants issued in October 2005 pursuant to the Rights – 3,240,000 common shares at \$1.50 per share until October 17, 2006;
- (iv) As to 490,000 Broker Compensation Warrants issued in March 2005 – 340,000 common shares at \$1.00 per share until October 17, 2006;
- (v) As to the 6,096,947 common share Purchase Warrants issued in November 2005 – 6,096,947 common shares at \$3.00 per share until May 8, 2007.

Upon the exercise of 350,000 Broker Compensation Warrants issued in 2004, a further 350,000 common share Purchase Warrants would be issued to acquire 350,000 additional common shares on the same terms as the common share Purchase Warrants issued in 2004. (Refer to (e)(i), above for details of exercise.)

Of the 490,000 Broker Compensation Warrants issued in March 2005, 150,000 were exercised in 2005, leaving 340,000 Broker Compensation Warrants outstanding. Upon their exercise, a further 170,000 common share Purchase Warrants would be issued to acquire 170,000 additional common shares on the same terms as the common share Purchase Warrants issued in March 2005. (Refer to (e)(iii), above for details of exercise.)

(f) Elimination of Deficit

On October 4, 2005 the company's shareholders approved a reduction to the stated capital account attributable to the common shares of the company by \$1,254,381.

(g) Stock Options

No stock options were granted in 2004; 2,437,000 were granted in 2005 at an average exercise price of \$1.04 per share.

All options have been granted for a period of five years. Of the 2,437,000 stock options granted in 2005, 1,557,000 stock options vest one-third upon grant, one-third one year after grant, and one-third two years after grant and 880,000 vest one-third one year after grant, one-third two years after grant, and one-third three years after grant. The table below summarizes unexercised stock options.

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life at December 31, 2005
\$0.50	800,000	4.1
\$0.51-\$1.00	940,000	4.6
\$1.01-\$2.00	697,000	4.9
	2,437,000	
Vested at December 31, 2005	519,000	

In 2005 a compensatory non-cash expense of \$124,427 (2004 - \$nil) was recorded, reflecting the fair value of stock options granted and vested during the year.

The fair value of each option granted in 2005 is estimated on the date of grant using the Black-Scholes option-pricing model with assumptions for grants as follows:

	Risk free interest rate	Expected life	Expected Volatility
Prior to initial public offering	3%	4 years	0%
Following initial public offering	3%	4 years	72%

The weighted average fair value at the date of grant of all options granted in 2005 was \$0.33 per option.

9. SEGMENTED INFORMATION

The Company has corporate offices in Canada and Barbados, with petroleum and natural gas operations in Argentina and Peru. The significant aspects of these operating segments are presented below.

	Corporate	Argentina	Peru	Total
2005				
Revenue, gross	114,098	2,750,110		2,864,208
Net earnings (loss)	(360,763)	8,264	(62,703)	(415,202)
Property and equipment	-	7,940,412	759,383	8,699,795
Capital expenditures	-	5,882,623	779,564	6,662,189
Total assets	20,441,657	10,198,727	940,414	31,580,798
2004				
Revenue, gross		122,973		122,973
Net earnings (loss)	(1,763)	(23,810)		(25,573)
Property and equipment		2,818,925		2,818,925
Capital expenditures		40,658		40,658
Total assets	845,730	3,038,217		3,883,946

10. RELATED PARTY TRANSACTIONS

Under the terms of a Management Services Agreement with Connacher, Connacher provides all management, operational, accounting and general and administrative services necessary or appropriate to manage and administer the company. The fee for this service was \$10,000 per month prior to Petrolifera's equity securities being listed and posted for trading on the Toronto Stock Exchange and \$15,000 per month until May 2007. The agreement may be immediately terminated for performance failure by the aggrieved party, or upon 30 days prior written notice by Connacher, or by mutual agreement. From time to time Connacher also pays bills on behalf of Petrolifera, for which it is reimbursed.

At December 31, 2005, the company owed Connacher \$221,131 pursuant to the Management Services Agreement, and for other amounts advanced (2004 - \$106,843).

In 2004 the company issued a \$4 million Promissory Note to Connacher as partial consideration for oil and gas properties acquired. The company repaid \$1.25 million in November 2004, repaid \$2 million in March 2005, and repaid the final \$750,000 in November 2005.



In 2005 the company paid professional legal fees in the amount of \$509,110 to a law firm in which an officer of the company is a related party. Transactions with the related party occurred within the normal course of business and have been measured at the exchange amount on normal business terms. The exchange amount is the amount of consideration established and agreed to with the related parties.

In consideration for the assistance provided to Petrolifera in securing two crude oil and natural gas exploration licenses in Peru and for the provision of financial guarantees respecting Petrolifera's annual work commitments in the licensed blocks in 2005, Connacher was granted an option to acquire 200,000 common shares at \$0.50 per share and was granted a 10 percent carried working interest ("CWI") through the drilling of the first well on each block. Petrolifera has the right of first purchase of this interest should Connacher elect to sell it at some future date. The CWI is convertible at the holder's election into a two percent gross overriding royalty on each license after the drilling of the first well on each license. These interests were effective upon the issuance of the licenses. The guarantees are limited to amounts specified over the terms of the licenses. Over the next 24 months, the guarantee is limited to US \$200,000. Connacher was subsequently indemnified by Petrolifera for this guarantee.

In consideration for his expertise and role in assisting the company in securing the two exploration licenses in Peru, an officer of the company received options to purchase 300,000 Common Shares at a price of \$0.50 per share, exercisable until February 1, 2010, a single payment of \$100,000 and pursuant to an overriding royalty agreement with the company, was granted a three percent gross overriding royalty ("GORR") on each of the two Peruvian blocks. The company recorded the \$100,000 payment as a capital expenditure; no accounting entry was necessary to record the GORR granted. The GORR vests over three years with one-third vesting immediately upon the issuance of the licenses, one-third vesting one year thereafter and the remaining one-third vesting two years after the issuance of the licenses. The company has the right of first purchase of the GORR at fair value should the officer elect to sell it at some future date.

In consideration for his expertise and role in assisting the company in securing the two licenses in Peru, another officer of the company received options to purchase 300,000 Common Shares at a price of \$0.50 per share, exercisable until February 1, 2010, and a success fee of \$20,000 upon the closing of the March 2005 private placement financing and a success fee of \$40,000 in November 2005, upon the company completing its IPO financing.

To assist in marketing the March 2005 private placement financing, the company retained PowerOne Capital Markets Limited ("PowerOne") as one of the selling agents. Prior to the March 2005 private placement financing, PowerOne was considered a connected issuer of Petrolifera because, together with its officers, directors and shareholders and associates of such persons, it owned 18 percent of the outstanding shares of the company. PowerOne received a commission for its services.

In March 2005 a Consulting Agreement with PowerOne was extended to November 2006 with a monthly fee of \$6,000.

An additional success fee ("PowerOne Success Fee") in the amount of \$326,786 was paid to PowerOne upon the company completing its initial public offering in November 2005.

11. SUPPLEMENTARY INFORMATION

(a) Per share amounts

The following table summarizes the common shares used in per share calculations.

For the periods ended December 31	2005	2004
Weighted average common shares outstanding	20,721,430	8,830,190
Dilutive effect of all stock options and all stock purchase warrants	11,081,933	-
Weighted average common shares outstanding - diluted	31,803,362	8,830,190

The effect of the per share calculations in each of 2004 and 2005 is anti-dilutive.

(b) Net change in non-cash working capital

For the periods ended December 31, 2005	\$
Accounts receivable	(1,860,623)
Prepaid expenses	(105,341)
Accounts payable	3,772,623
Due to a related company	114,288
Total	1,920,947

(c) Supplementary cash flow information

For the periods ended December 31	2005	2004
	\$	\$
Interest paid	92,196	-
Income taxes paid	-	-

12. COMMITMENTS, CONTINGENCIES AND GUARANTEES

In 2005 Petrolifera acquired two significant oil and gas exploration licenses in Peru. The licenses have a total US \$41.8 million financial commitment to complete negotiated work programs on the two licenses over seven years. The Company has the right to withdraw from the licenses at the end of each period associated with the term of the licenses.

In 2005 the company issued letters of credit in the amount of US\$200,000 to secure the capital expenditure requirements associated with the first work program on two exploration licenses in Peru.

The Company's annual commitments under management, consulting and operating agreements are as follows:

2006 - \$900,000; 2007 - \$694,000; 2008 - nil; 2009 - nil; thereafter - nil.

Additionally, the Company has various guarantees and indemnifications in place in the ordinary course of business, none of which are expected to have a significant impact on the Company's financial statements or operations.

CORPORATE INFORMATION

OFFICERS

Richard A. Gusella
Executive Chairman

Gary D. Wine
President

Richard R. Kines
Chief Financial Officer

Jennifer K. Kennedy
Corporate Secretary
Partner, Macleod Dixon LLP

BOARD OF DIRECTORS

Richard A. Gusella
Executive Chairman

Gary D. Wine
President

Donald D. Barkwell ^(1,2,4)
Chairman, Human Resources
Committee
Chairman, Reserve Subcommittee
of the Audit Committee

Colin M. Evans ⁽⁴⁾

Gerrit T. Maureau ^(1,2,3,4)
Chairman, Governance Committee

Stewart D. McGregor ⁽³⁾

Christopher Smith ^(1,2,3)
Chairman, Audit Committee

- (1) Audit Committee
- (2) Reserve Subcommittee of the Audit Committee
- (3) Governance Committee
- (4) Human Resources Committee

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SUBSIDIARIES

Petroliera Petroleum
(Holdings) Limited
(Barbados)

Petroliera Petroleum
(Peru) Limited
(Barbados)

Petroliera Petroleum
(Americas) Limited
(Barbados)

Petroliera Petroleum
del Peruana S.A.C.
(Peru)

TSX LISTING

Common shares: PDP
Warrants: PDP.WT

CUSIP NUMBER

716709100

ISIN

CA7167091007

SOLICITORS

Macleod Dixon LLP
Calgary, Alberta

Maciel, Norman and Asociados
Buenos Aires, Argentina

Estudio Galvez
Lima, Peru

BANKERS

National Bank of Canada
Royal Bank of Canada (Barbados)

AUDITORS

Deloitte & Touche LLP

RESERVOIR ENGINEERS

DeGolyer and MacNaughton Canada Limited

ABBREVIATIONS

bbls	barrels
bbl/d	barrels per day
bcf	billion cubic feet
boe	barrels of oil equivalent
boe/d	barrels of oil equivalent per day
DCF	discounted cash flow
GJ	gigajoule
mbbls	thousand barrels
mboe	thousand barrels of oil equivalent
mcf	thousand cubic feet
mcf/d	thousand cubic feet per day
mmbbls	million barrels
mmboe	million barrels of oil equivalent
mmcf	million cubic feet
mmcf/d	million cubic feet per day
NGL	natural gas liquids
PNG	petroleum & natural gas
PV	present value
WI	working interest
WTI	West Texas Intermediate



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